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# THE EFFECT OF THE TAX REFORM ACT OF 1976 UPON FEDERAL TAX CONSEQUENCES OF ORDINARY TRANSACTIONS IN REAL ESTATE

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## INTRODUCTION

On October 4, 1976, the Tax Reform Act of 1976 [hereinafter the Act] became law. Shortly thereafter, our article entitled *Federal Tax Consequences of Ordinary Transactions in Real Estate* was published.<sup>1</sup> The provisions of the Act made broad changes to the existing tax laws of the Internal Revenue Code of 1954 [hereinafter the Code]. Many of those changes affect the federal tax consequences of ordinary real estate transactions. Accordingly, to bring our recently published article up to date, this sequel has been written.

Some of the changes made by the Act may be applicable to a number of statements in the original article. However, for ease of reference, the changes are discussed with respect to that segment of the article where the impact is most direct.

## TAX CLASSIFICATION OF REAL ESTATE<sup>2</sup>

This portion of the original article discussed real estate held for the production of income. In this regard, the Act amended the Code<sup>3</sup> by providing a limit on the deduction for expenses attributable to the rental of a vacation home. The limitation

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1. Meldman & Weine, *Federal Tax Consequences of Ordinary Transactions in Real Estate*, 60 MARQ. L. REV. 61 (1976) [hereinafter cited as Meldman & Weine].

2. This section supplements § III of Meldman & Weine, *supra* note 1, at 65.

3. Tax Reform Act of 1976, Pub. L. 94-455, Title V § 601(a), 90 Stat. 1569 (1976) added I.R.C. § 280A.

applies if the personal use of the vacation home by the taxpayer-owner during the year for which a deduction is sought exceeds the greater of (a) fourteen days, or (b) ten percent of the number of days during the year that the vacation home is actually rented.<sup>4</sup>

If the limits for personal use are exceeded, the deductions attributable to renting the home<sup>5</sup> cannot exceed the gross income derived from renting the home less the deductions which are not attributable to renting the vacation home.<sup>6</sup> Further, deductions attributable to renting the home are limited to the proportion which actual rental days bear to total days of use of the property multiplied by the business expenses attributable to renting the home.<sup>7</sup>

If the limits for personal use are not exceeded the deduction limitations are not applicable. If the owner rents the home for less than fifteen days during a year, none of the rental income nor deductions attributable thereto shall be taken into account in his federal income tax return for the year.<sup>8</sup> Section 280A is effective for taxable years beginning after December 31, 1975.<sup>9</sup>

#### TAXABILITY OF SALES OR EXCHANGES THE BASIS OF PROPERTY<sup>10</sup>

The Act made what may be termed revolutionary changes with respect to the basis of inherited real estate.<sup>11</sup> The new law provides that the basis of property acquired from a person dying after December 31, 1976 shall be the same in the hands of the acquiring person as it was in the hands of the decedent immediately prior to his death. To avoid making pre-1977 appreciation subject to the new rules, however, for purposes of determining gain (but not loss), the basis of assets will be stepped up to their fair market value on December 31, 1976. To avoid having to make appraisals to determine what the fair

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4. I.R.C. § 280A(d)(1).

5. Such deductions may include depreciation, insurance, and utilities.

6. These deductions include interest, property taxes, and casualty losses.

7. I.R.C. §§ 280A(c)(4) and (e).

8. I.R.C. § 280A(g).

9. Tax Reform Act of 1976, Pub. L. 94-455, Title VI, § 601(c), 90 Stat. 1569 (1976).

10. This section supplements § IV. B. of Meldman & Weine, *supra* note 1, at 67.

11. Tax Reform Act of 1976, Pub. L. 94-455, Title XX, § 2005(a)(1), 90 Stat. 1872 (1976) amended I.R.C. § 1014(d) and added a new I.R.C. § 1023 which sets forth the rules relating to the basis of property inherited from a decedent dying after December 31, 1976.

market value of real state was on December 31, 1976, the basis of the property at December 31, 1976 will be determined by assuming that appreciation of the property, since it was acquired by the decedent, occurred ratably over the full period of time the decedent held the property. The basis of the property will also be increased by the federal and state estate taxes and state inheritance taxes attributable to the net appreciation in value for the property.<sup>12</sup> However, after adjustment for death taxes, the basis cannot exceed the fair market value of the property.<sup>13</sup>

#### CAPITAL GAINS AND LOSSES<sup>14</sup>

The Act<sup>15</sup> lengthened the holding period for long-term capital gains and losses from more than six months to more than nine months for the year 1977, and from more than nine months to more than twelve months for the year 1978 and later years.

In conjunction with the change relating to the holding period for long-term capital gains and losses, it is important to be aware that the Act<sup>16</sup> amended the Code<sup>17</sup> with regard to the minimum tax for tax preferences.<sup>18</sup> As a result of this amendment, one pre-Act item of tax preference for individuals, the amount allowable under the fifty percent capital gains deduction,<sup>19</sup> has become much more important for taxable years beginning after December 31, 1975.<sup>20</sup>

The change in the Code increased the rate of the minimum tax on individuals from ten percent to fifteen percent, reduced the exemption to the greater of (a) \$10,000 or (b) one-half of the taxpayer's regular income taxes, and added new tax preference items.<sup>21</sup> One of the new tax preference items, referred to

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12. I.R.C. §§ 1023(c), (e). *See also* I.R.C. § 1023(d) for a possible increase in basis to \$60,000 with respect to certain estates.

13. I.R.C. § 1023(h)(2).

14. This section supplements § IV. C. of Meldman & Weine, *supra* note 1, at 68.

15. Tax Reform Act of 1976, Pub. L. 94-455, Title XIV, § 1402, 90 Stat. 1731 (1976).

16. Tax Reform Act of 1976, Pub. L. 94-455, Title III § 301, 90 Stat. 1549 (1976).

17. I.R.C. §§ 56, 57.

18. I.R.C. § 56(a).

19. I.R.C. § 57(a).

20. With certain exceptions the amendments respecting the minimum tax are applicable for taxable years beginning after December 31, 1975. Tax Reform Act of 1976, Pub. L. 94-455, Title III § 301(g), 90 Stat. 1553, *amended by* Pub. L. 94-568, § 3, 90 Stat. 2697 (1976).

21. Other rules apply to corporations in this regard. *Id.*

as "excess itemized deductions,"<sup>22</sup> can easily, though indirectly, affect individuals involved in real estate transactions.<sup>23</sup> Its application depends upon a taxpayer's individual circumstances viewed on an annual basis.

#### DEPRECIABLE REAL PROPERTY AND SECTION 1250

The Act<sup>25</sup> has again changed the rules relating to depreciable real property. However, the changes made by the Act only affect the recapture rules for depreciation on residential real estate. The effect of the changes is to treat gain on the sale or exchange of the property as ordinary income, to the extent of all post-1975 depreciation in excess of straight-line.

Full recapture will be required for post-1975 accelerated depreciation. In the case of certain government subsidized housing, the amount recaptured is phased out during the second hundred months the property is held.<sup>26</sup> The foregoing changes in the treatment of depreciation recapture are applicable to taxable years ending after December 31, 1975.<sup>27</sup>

#### SECTION 1250 RECAPTURED DEPRECIATION—COMPUTATION RESIDENTIAL HOUSING RECAPTURED DEPRECIATION<sup>28</sup>

The changes made by the Act have caused taxpayers to make three separate computations to determine the amount of additional (amount in excess of straight-line) depreciation they must recapture pursuant to section 1250 of the Code. Post-1975 additional depreciation is computed first. If the excess post-1975 depreciation is greater than the gain on the sale, then the amount of recaptured depreciation will be limited to the gain on the sale. If the excess post-1975 depreciation is less than the gain, then all of the excess post-1975 depreciation will be recaptured and calculations must then be made to determine how much additional depreciation taken during the periods 1970

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22. The specific definition is set forth in I.R.C. § 57(b).

23. Excess itemized deductions do not constitute an item of tax preference for corporations. Tax Reform Act of 1976, Pub. L. 94-455, Title III, § 301(c). 90 Stat. 1552 (1976).

24. This section supplements § VI of Meldman & Weine, *supra* note 1, at 73.

25. Tax Reform Act of 1976, Pub. L. 94-455, Title II, § 202, 90 Stat. 1527 (1976).

26. I.R.C. § 1250(a), as amended by Tax Reform Act of 1976, Pub. L. 94-455, Title II, § 202, 90 Stat. 1527 (1976).

27. Tax Reform Act of 1976, Pub. L. 94-455, Title II, § 202(d), 90 Stat. 1530 (1976).

28. This section supplements § V. B. of Meldman & Weine, *supra* note 1, at 79.

through 1975 and 1963 through 1969 must be recaptured. Finally, the post-1975, the 1970 through 1975, and the 1963 through 1969 amounts of additional depreciation are added. The total, to the extent of the amount of gain on the sale, is reported as ordinary income.

#### SALES OF DEPRECIABLE PROPERTY TO RELATED INTERESTS<sup>29</sup>

The Act<sup>30</sup> amended the Code<sup>31</sup> with respect to sales or exchanges of depreciable property taking place between related parties after October 4, 1976.<sup>32</sup> The amendment expanded the law to cover a sale or exchange of depreciable property between commonly controlled corporations. Further, the rules of constructive ownership were expanded to include the taxpayer's parents, adult children, and any trust, estate or partnership in which the taxpayer is a beneficiary or partner. In addition, the Act amendment lowered the minimal stock ownership among the related parties for the statute to apply from more than eighty percent of the stock's value to eighty percent or more in value of the outstanding stock.<sup>33</sup>

#### SALE AND PURCHASE OF RESIDENCE EXCLUSION OF GAIN OVER AGE 65<sup>34</sup>

For taxable years beginning after December 31, 1976, the \$20,000 exclusion from gross income with respect to the sale of an individual's principal residence has been increased to \$35,000.<sup>35</sup>

#### CONCLUSION

Various aspects of an ordinary transaction in real estate have been broadly affected by the Tax Reform Act of 1976. To serve their clients well, attorneys must become familiar with the changes it has wrought.

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29. This section supplements § VI. C. of Meldman & Weine, *supra*. note 1, at 80.

30. Tax Reform Act of 1976, Pub. L. 94-455, Title XXI, § 2129(a), 90 Stat. 1922 (1976).

31. I.R.C. § 1239.

32. Tax Reform Act of 1976, Pub. L. 94-455, Title XXI, § 2129(a), 90 Stat. 1922 (1976).

33. I.R.C. § 1239(b).

34. This section supplements § IX. B. of Meldman & Weine, *supra* note 1, at 87.

35. I.R.C. § 121(b)(1).

