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**Seller
Financing
Defers Taxes
and Creates
Income**

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**§1030
 Reinvestment
 Scenarios**

Glossary

SAMPLE



The mortgage interest deduction (MID), a subsidy



After reading this chapter, you will be able to:

- advise homebuyers on the mortgage interest deduction (MID), the subsidy available to them when they use purchase-assist and equity financing to buy a first or second home;
- explain the distinction between itemized personal deductions and the standard personal deduction; and
- identify requirements for a homebuyer to qualify for use of the MID.

itemized deduction

mortgage interest deduction (MID)

qualified interest

A long-standing policy of the federal government is to encourage **residential tenants** to favor mortgaged homeownership, not renting, for their monthly expenditures on shelter. To shape this bias, the government uses the tax code to deliver an annual subsidy to buyers who **finance the purchase** of their principal residence or a vacation home. The social policy is propagandized through the news media using the slogan “The American Dream.”

The homebuyer receives this mortgage subsidy in the form of an annual reduction in their income taxes allowed by the **mortgage interest deduction (MID) rules**. Tenants have no equivalent personal subsidy for the cost of their shelter.

The MID creates an incentive to permanently own a residence, bound to it by title and a 30-year mortgage debt. One downside is the mortgaged homeowner and family have reduced job mobility and impaired financial flexibility.

Chapter 1

Learning Objectives

Key Terms

Two residences, alternative deductions

mortgage interest deduction (MID)

An itemized personal deduction permitted for interest accrued and paid on mortgages secured by a homeowner's principal and second residence.

itemized deduction

Deductions taken by a homeowner for allowable personal expenditures such as mortgage interest (MID) and state income and local property taxes (SALT) as itemized on Schedule A which reduce their taxable income and tax liability. Contrast with the standard personal deduction.

Homeowners process the MID as an **itemized personal deduction** subtracted from their **adjusted gross income (AGI)**. The result is a reduced amount of taxable income, and in turn reduced tax liability.

When a mortgaged homeowner prepares their tax return, they have two alternatives for reporting personal deductions:

- *itemize* and total all their deductible expenditures — charitable gifts, medical expenditures, state income taxes, property taxes and home mortgage interest; or
- take the *standard deduction* (a fixed amount set at \$12,000 for individuals, \$18,000 for heads of household and \$24,000 for married individuals filing jointly).¹

When the amount of permissible itemized expenditures exceeds the amount of the standard deduction, it is beneficial for the homeowner to itemize their deductions.

The real estate-related itemized deductions a homeowner takes — reported on Schedule A — fall into two categories:

- the MID, a deduction of interest accrued and paid, limited to interest on up to \$750,000 of combined mortgage principal;² and
- homeowner property taxes combined with state income tax, together limited to a total of \$10,000.³

As a subsidy, the MID incentivizes individuals to own and finance the purchase or improvement of their principal residence and second home rather than renting. No mortgage financing, no interest deduction. Implicitly, mortgage payments are the economic equivalent of rent paid as tenants. However, tenants have no tax incentive to rent.

For a residential tenant considering a plan to minimize their future income taxes, the monthly payment on a purchase-assist mortgage as implicit rent goes beyond that of a mere substitute for renting. When itemized, mortgage interest paid reduces their taxable income – the reduction being the subsidy for homeownership.

The amount of reduction in taxes due to mortgage homeownership depends on the homeowner's tax bracket, which ranges from 10% to 37%. The tax bracket rate sets the subsidy amount received as the taxes avoided at the homeowner's tax rate on income equal to the mortgage interest paid on principal up to \$750,000.

With the MID, interest accrued and paid on a home mortgage is deductible from income when the mortgage:

- funded the purchase price or the cost of improvements for the owner's principal residence or second home; and
- is secured by either the owner's principal residence or second home.⁴

¹ Internal Revenue Code §63(c)(7)(A)]

² IRC §163(h)(3)(F)

³ IRC §164(b)(6)

⁴ Internal Revenue Code §163(h)(3)(B)

The MID reduces the property owner's taxable income under both the **standard income tax (SIT)** and the **alternative minimum tax (AMT)** rules for setting the owner's income tax liability. The *AMT* is a supplemental income tax analysis targeting high-income earners who have a high ratio of SIT deductions.

Interest paid on lender and carryback sales mortgages which fund the **purchase or substantial improvement** of an owner's first or second home is deductible on combined mortgage principal up to \$750,000 for an individual and couples filing a joint return. The mortgage balances are limited to \$375,000 for married persons filing separately.

Thus, when principal collectively exceeds \$750,000 for mortgage funds used to acquire, construct, or further improve a principal residence or second home, only the interest paid on the first \$750,000 is deductible.

New improvements paid for with mortgage funds need to be substantial for interest on the mortgage to qualify for the MID. To qualify for MID, improvements must:

- add to the property's market value;
- prolong the property's useful life; or
- adapt the property for residential use.

Mortgage funds used to repair property and maintain its good condition do not qualify for funding of substantial improvements.⁵

Homeowners often **refinance** an existing purchase-assist/improvement mortgage, especially during recessionary periods with lowered mortgage rates. Here, interest on the principal portion of the refinancing used to fund payoff of a MID mortgage qualifies for MID treatment. Conversely, interest paid on principal generated by refinancing which exceeded the payoff amount for the existing purchase-assist/improvement mortgage(s) does not qualify for the MID.

For example, a homeowner takes out a \$500,000 mortgage to fund the purchase of their principal residence. The mortgage principal balance is now paid down to \$400,000. The owner needs cash funds and refinances the residence, paying off the original purchase/improvement mortgage. As intended, the proceeds from the refinancing exceed the amount of the payoff demand on the MID mortgage.

In this scenario, interest on only \$400,000 of the refinancing qualifies for MID reporting, unless the excess funds generated by the refinance funded substantial improvements to the residence.

Purchase/ improvement mortgages

Refinancing limitations

⁵ T204783

Qualifying the principal residence and second home

For interest on purchase-assist or improvement mortgage funds to be itemized as MID, the mortgages must be secured by the homeowner's **principal residence** or **second home**.

A *principal residence* is an individual's home when:

- the homeowner resides in it a majority of the year;
- the home is located close to the homeowner's place of employment and banks which handle the homeowner's accounts; and
- the home's address is used for tax returns.⁶

A *second home* is any residence selected by the owner. The selection may be changed from year to year and includes mobile homes, recreational vehicles and boats or real estate.

Second homes are often **rented out** during the year. When rented, the mortgage interest paid qualifies to be itemized as a MID when during the year the owner occupies the property for the greater of:

- more than 14 days; or
- at least 10% of the number of days the residence is rented.⁷

When the owner **does not rent** out their second home during the year, the property qualifies for the MID whether the owner occupies it or not.⁸

Any rental income the owner receives from a tenant occupant of the second home is reported as **investment/portfolio income** when the owner qualifies for the MID by occupying the property in excess of the 14-day/10% rule.

The owner may not treat a second home they have rented to tenants as a passive income category rental property when the owner's family occupies the property for more than the threshold 14 days or 10% of the days rented during the year. With the family use exceeding the threshold, the second home is reported as a portfolio income category asset and the home mortgage interest qualifies for the MID treatment.

Conversely, the owner may not report the property as a passive income category investment to write off interest on principal in excess of \$750,000. Further, they may not take depreciation deductions on the second home much less deduct the cost of repair and maintenance. A property which qualifies as a second home is not a passive income category asset though it is a portfolio category investment.⁹

However, a second home, when purchased for personal use while held for a profit on resale, qualifies as investment (like-kind) property for exemption from profit taxes under IRC §1031.¹⁰

⁶ IRS Publication 523

⁷ IRC §280a(d)(1)

⁸ IRC §163(h)(4)(A)(iii)

⁹ IRC §163(h)(4)(A)(i)(II); 280a(d)(1)

¹⁰ IRC §1031; IRS Private Letter Ruling 8103117

The MID is only allowed for interest which accrued and was paid during the tax year, called **qualified interest**.¹¹

Procedurally, an owner deducts interest on first and second home mortgages from their adjusted gross income (AGI) as an itemized deduction to set their taxable income and thus their tax liability. In contrast, interest paid on business, passive/rental or portfolio investment mortgages reduces the owner's AGI as interest offsets income from assets and services within each income category before setting the AGI.

When a homeowner takes the standard deduction, the MID is not involved as it is taken only as an itemized deduction.¹²

Consider a homeowner who mortgages the equity in their home to fund the down payment on the purchase of an income-producing property. They execute a note as evidence of a money debt owed a lender or carry-back seller who extends credit in lieu of a larger cash down payment.

The homeowner wants to avoid the MID limitation on mortgages secured by the principal residence or second home. They want to be able to write off all the interest paid on the note against future income from the property they purchased by executing the note.

To do this, the homeowner negotiates with the lender or carry-back seller to secure the note by **two separate trust deeds**: one as a lien on the home and the other as a lien on the property purchased. This is not a blanket trust deed covering two parcels, but two trust deeds each for a different properties for the same debt.

The lender or carry-back seller is satisfied with the financial risk regarding the loss of principal. They view the home secured by the trust deed as the primary source of recovery should the owner default on the note.

In addition to the owner's home, the note is secured by a second trust deed on the property purchased. The buyer needs justification for writing off the entire interest accrued and paid on the mortgage against income from the property purchased with the loan or carryback mortgage. Here, the home equity is used as **additional security** under a separate trust deed from the one secured by the investment property purchased to avoid the MID taint.

Only one debt for which there is one note, but two trust deeds each referencing the same debt owed. However, arranging a blanket trust deed describing both properties risks imposition of MID limitations which the owner wants to avoid.

While purportedly created to encourage low- to-middle-income households to become owners and benefit financially, the MID is mostly limited to disproportionately increasing the wealth of high-income homeowners.

Taking the deductions

The home as additional security

qualified interest

Mortgage interest accrued and paid on up to \$750,000 of mortgage principal used to fund the acquisition or improvement of the homeowner's principal residence or second home. The interest is itemized on Schedule A as an itemized personal deduction which reduces the homeowner's taxable income and tax liability.

Economic effects of the MID

¹¹ IRC §163(h)(3)(A)

¹² IRC §63; IRC §163(h)(3)(F)

Form 223
 Supplemental
 Truth-In-Lending
 Section 32
 Disclosure

SUPPLEMENTAL TRUTH-IN-LENDING SECTION 32 DISCLOSURE
 Additional Disclosures for Reg Z Section 32

NOTE: This form is used by a mortgage loan originator (MLO) when processing an application for a consumer mortgage secured by the borrower's principal residence and the interest rate or points and fees exceed Regulation Z Section 32 threshold amounts, to provide a Reg Z Section 32 notice disclosing the total loan amount and Applicable Percentage Rate (APR) to the borrower.

DATE: _____, 20____, at _____, California.

1. Prepared by _____
 1.1 Address _____
 1.2 Phone _____ Email _____
Items left blank or unchecked are not applicable.

FACTS:

2. Lender identification _____

3. Borrower identification _____

4. Loan Broker identification _____

5. Account or application number _____

6. **NOTICE TO BORROWER:**
 You are not required to complete this agreement merely because you have received these disclosures or have signed a loan application. If you obtain this loan, the lender will have a mortgage on your home. You could lose your home, and any money you have put into it, if you do not meet your obligations under the loan.

7. **AMOUNT BORROWED:**
 The principal amount borrowed on the personal-use loan is \$ _____.
 7.1 The amount borrowed is the amount of the loan under the loan application.

8. **ANNUAL PERCENTAGE RATE:**
 The annual percentage rate of the charges on the loan is _____%.

9. **PAYMENTS:**
 Your regular monthly _____ payment will be \$ _____.

10. **FINAL/BALLOON PAYMENT:**
 Your final/balloon payment, if any, will be \$ _____.
 10.1 This payment is due more than five years after the loan is originated.

Borrower acknowledges receipt of a copy of this disclosure statement.
 Date: _____, 20____

Borrower's Signature: _____

Borrower's Signature: _____

FORM 223
03-11
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High-income earners — who are more likely to own a home and have a greater sum of personal deductions — itemize their deductions instead of claiming the **standard deduction**.

Additionally, the size of the subsidy is directly proportional to the amount of the mortgage, and thus the associated property value. The wealthier the homeowner the greater the price they pay for a home and the larger the mortgage, and in turn the bigger the tax savings.

However, consider the ultimate beneficiaries of the MID as lobbyists for its continuance to include **homebuilders, sellers, brokers and lenders**. Without the income tax reduction for itemizing interest as the MID, the

typical homebuyer overextends themselves to pay the price a seller asks for a property. Thus, without the MID refund, buyers are going to pay less for the same property as sellers are confronted with buyers who have no subsidy.

The MID operates to directly inflate home prices. Buyers taking out purchase-assist mortgages have more disposable income to spend on the same property due to the MID reduction in their income taxes. Essentially, buyers are reimbursed for overpayment to sellers by reduced income taxes through the MID.

However, most homebuyers have insufficient financial posture to be able to benefit by itemizing their deductions. Thus, most mortgaged homeowners of low-to-mid-tier priced housing no longer receive the subsidy, or as much subsidy, depending on the level of their wealth.

Worse for availability of the subsidy, the 2018 increase in the *standard deduction* greatly increased the likelihood most current or prospective homeowners will take the standard deduction, as opposed to itemizing their deductions. This shift decreases the availability of MID to benefit low- and middle-income households, a condition which tends to lower the price they can pay. This factor, while working to depress home prices, is offset by any trend in lower mortgage interest rates that increases the buyer's ability to borrow more mortgage money based on the same income.

To encourage homeownership, the federal government offers an annual subsidy to homeowners called the mortgage interest deduction (MID).

When a mortgaged homeowner prepares their tax return, they can either itemize their deductions. The MID is an itemized personal deduction taken for interest accrued and paid on mortgages secured by a homeowner's principal and second residence.

Itemized Deductions are deductions taken by a homeowner for allowable personal expenditures such as mortgage interest and state and local property taxes (SALT) as itemized on Schedule A which reduces their taxable income and tax liability.

Homeowners process the MID as an itemized personal deduction subtracted from their adjusted gross income (AGI). The result is a reduced amount of taxable income, and in turn reduced tax liability.

When the amount of permissible itemized expenditures exceeds the amount of the standard deduction, it is beneficial for the homeowner

Chapter 1 Summary

to itemize their deductions. When a homeowner takes the standard deduction, the MID is not involved as it is taken only as an itemized deduction. The MID operates to directly inflate home prices.

Chapter 1
Key Terms

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SAMPLE