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Taxpayer Relief Act of 1997
—New Provisions Affecting Ownership or Use of Real Property

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Relatively few of the amendments made to the Internal Revenue Code by H.R. 2014, the Taxpayer Relief Act of 1997 (the “Act”), expressly relate to real property. We discuss below certain provisions of the Act of relatively broad application that either expressly relate to the ownership or use of real property or are otherwise likely to affect such activities.

A cautionary note: Many of the Act’s provisions, including those relating to the reduction in capital gains rates, are remarkably complex. Close study has already revealed circumstances in which the new provisions do not appear to work as intended, and additional problems will no doubt become apparent over time.

The summary below does not delve into these “glitches” and does not address many specific transitional rules. A careful review of the new provisions will be necessary in determining their application to any particular set of circumstances.

Reduction in Capital Gains Rates

The stated maximum rate of tax for individuals on capital gains recognized with respect to property held for more than 18 months has been reduced to 20%.

The maximum rate on capital gains is further reduced, to 18%, with respect to gain from the sale or exchange of property which is acquired after the year 2000 and held for more than 5 years. An election may be made, with respect to readily tradable stock and certain other property held on January 1, 2001, to treat the property for which the election is made as having been sold and reacquired at that time (with any resulting gain being recognized). The election will enable any subsequent gain with respect to such property to qualify for taxation at the lower 18% rate, if the other requirements for that rate are met.

The applicable rates for 18-month and 5-year property are reduced to 10% and 8%, respectively, for certain taxpayers having taxable income which would (without regard to the special rates for capital gains) be taxed at a rate below 28%. The 8% rate generally applies to gain recognized by such taxpayers after the year 2000 on property held for more than 5 years, without regard to whether the holding period for such property commenced after 2000.

The new rates do not apply with respect to gain attributable to property held for 18 months or less; to gain from "collectibles" such as works of art, stamps, and coins; or to gain from the sale or exchange of qualified small business stock eligible for the pre-existing 50% exclusion for such transfers. They do apply for purposes of the alternative minimum tax.

The new rates do not apply, in general, to long-term capital gains (that is, on property held for more than one year) attributable to "section 1250 property" (that is, most depreciable real property), to the extent of all depreciation claimed with respect to that property. Such gains will generally be taxed at a rate of 25%. For example, if a person who bought real property for $1,000, which has been depreciated over a period of years to $500, now sells the property for $1,200, $500 of the gain will be taxed at a maximum rate of 25% and the balance of the gain will be taxed at a maximum rate of 20%.

The capital gains rate amendments are generally effective for taxable years ending after May 6, 1997. The old 28% maximum rate continues to apply to "mid-term gain," which is, in general, (i) the net capital gain "taking into account only the gain or loss properly taken into account after July 28, 1997, from property held for more than 1 year but not more than 18 months" and (ii) in the case of a taxable year that includes May 7, 1997, "gains and losses properly taken into account for the portion of the taxable year before May 7, 1997."

Long-term capital gains properly taken into account from May 7 through July 28, 1997, are thus generally taxed at the new rates without regard to whether the property was held for more than 18 months.

Gain from Sale of Principal Residence

Code section 1034, the longstanding "rollover" provision with respect to gain from the sale of a principal residence, has been repealed, and Code section 121 has been replaced with a new provision that excludes from gross income gain from the sale or exchange of property if, during the 5-year period ending on the date of disposition, the property was owned and used by the taxpayer as the taxpayer's principal residence for at least 2 years. If the taxpayer is a tenant-stockholder in a cooperative housing corporation, the ownership requirement is applied to the stock and the use requirement is applied to the apartment which the taxpayer was entitled to occupy as a tenant-stockholder.

Generally, the maximum amount of gain excluded under section 121 with respect to a sale is $250,000. This exclusion is increased to $500,000 if (i) a husband and wife file a joint return for the year of the sale; (ii) *either* spouse meets the two-year ownership requirement; (iii) *both* spouses meet the two-year use requirement; *and* (iv) neither spouse is ineligible for the benefits of the exclusion by reason of the separate rule that precludes the application of the exclusion to more than one sale within a 2-year period (the 1-sale-in-2-years rule).

An election may be made not to have the section 121 exclusion apply to a particular sale. This election may be helpful in ameliorating the impact of the 1-sale-in-2-years rule.

It is apparent that sales that would have come within the old rollover rule may not qualify under the new exclusion, for example, by reason of the two-year ownership and use requirements. If a sale of a principal residence fails to meet the ownership and use tests or the 1-sale-in-2-years rule, a portion (determined by formula) of the generally available exclusion will nonetheless apply if the sale is by reason of a change in employment, health, or, to the extent provided in regulations, "unforeseen circumstances."

For example, if gain of $200,000 is realized with respect to a sale of a principal residence required by the owner's job relocation, and a $500,000 exclusion would be available under section 121 but for the seller's having owned and used the property as a personal residence for only nine months, the exclusion will apply to the extent of 9/24ths of $500,000, or $187,500, and $12,500 of the gain will be included in income.

The exclusion does not apply, in general, to the extent of depreciation allowed which is attributable to periods after May 6, 1997. For example, if a property used by the owner for 2 years or more as a principal residence is rented to others for 2 years and then sold immediately thereafter, any resulting gain will be included in income notwithstanding the general exclusion, to the extent of depreciation for the two-year rental period.

It is not very unusual for the built-in gain with respect to a long-time principal residence to approximate or exceed $250,000 or even $500,000, particularly taking into account that a homeowner's basis may be lower than cost by reason of prior adjustments to basis pursuant to section 1034. In such situations, the homeowner's financial and tax planning should take into account that any further appreciation with respect to that residence will not be excluded from income by this provision if and when realized by the homeowner.

It is also apparent that prudent homeowners will continue to maintain records regarding post-acquisition improvements affecting basis, so as to minimize any gain potentially subject to tax where the new provision does not apply at all or is not sufficient to shelter the entire gain.

The amendment of section 121 and the repeal of section 1034 are generally effective for sales or exchanges after May 6, 1997, subject to transitional provisions which provide for, inter alia, elections to apply the old rules to sales completed before August 5, 1997, or thereafter pursuant to contracts binding on that date.

Tenant Construction Allowances

New Code section 110, effective for leases entered into after August 5, 1997, provides a safe harbor for the exclusion from a tenant's income of payments received from a lessor for the purpose of the tenant's construction of certain improvements. The safe harbor added by the Act is quite narrow, however, applying only to amounts received in cash (or treated as a rent reduction) by a tenant from a landlord (a) under a lease for 15 years or less of "retail space," (b) for the purpose of the tenant's constructing or improving "qualified long-term real property" for use in the tenant's trade or business, and (c) only to the extent that such amounts do not exceed the amount expended by the tenant for such construction or improvement.

"Qualified long-term real property" is defined as nonresidential real property which is "part of, or otherwise present at," the retail space to which the lease relates and which reverts to the landlord at the termination of the lease. "Retail space" is defined as real property used by the tenant in selling tangible personal property or services to the general public.

The new provision specifically provides that property built or improved with amounts received from a landlord and excluded from a tenant's income under section 110 must be treated as nonresidential real property of the landlord, presumably with the amounts paid by the landlord (or treated as a rent reduction) being includible in the landlord's tax basis for the property. This suggests that, where a lease or related agreement provides for payments some or all of which may be within the scope of this provision, consideration should be given to designating in the lease or other agreement the payments believed to be within the scope of section 110, and to an agreement between the landlord and the tenant to file their returns on a consistent basis.

Other Provisions

Many other provisions of the Act will affect investments in real estate. These provisions include the numerous changes made to the Code provisions relating to real estate investment trusts, or "REITs," largely with the intent of resolving certain technical issues and facilitating the continued qualification of such entities for the favorable tax treatment accorded to REITs.

Amendments relating to partnerships include: changes in the manner of allocating basis between properties distributed by a partnership; revision of the "hot asset" rules of section 751 that apply where interests in partnerships owning "inventory items" or "unrealized receivables" are sold; and extensive changes to the partnership audit procedures.

In addition, Code section 1234A was amended to apply for the first time to rights and obligations relating to interests in real property. That section now characterizes as "gain or loss from the sale of a capital asset" any "[g]ain or loss attributable to the cancellation, lapse, expiration, or other termination of . . . a right or obligation with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer . . . ." The amendment is effective for terminations occurring more than 30 days after August 5, 1997.

Section 1234A deals with a problem that arises because the Internal Revenue Code applies favorable capital gains rates only where the gain is realized upon the "sale or exchange" of a capital asset. If a contractual right or obligation is cancelled, extinguished, or otherwise terminated upon making a payment, the courts have held in a variety of situations that the recipient of the payment does not have a capital gain because the right or obligation was "extinguished," not "sold or exchanged." Section 1234A reverses this result by providing that the gain or loss "shall be treated as gain or loss from the sale of a capital asset."

The one real estate case that the Senate Finance Committee clearly had in mind, as described in the committee report, was "the tax treatment of amounts received [by a landlord] to release a lessee from a requirement [in the lease] that the premise [sic] be restored on termination of the lease."

That kind of payment to a landlord will now be given capital gain treatment.

The language of section 1234A may cover much more than the example described in the Finance Committee report, however, and is likely to engender much debate and uncertainty. It seems likely to the authors, for example, that the amendment to section 1234A was not intended to confer capital gains treatment on ordinary lease termination payments made by a lessee to a lessor—but the language of the statute may have created some uncertainty as to whether such payments will ultimately be viewed as falling under the new provision.

Also, in many real estate situations a taxpayer's ability to qualify for capital gains treatment under section 1234A will be compromised by the fact that depreciable property and any real property used in a taxpayer's trade or business is simply not a capital asset, as that term is defined in Code section 1221. It is beyond the scope of this article, however, to discuss the pros and cons of the various positions that may be espoused by energetic and imaginative tax advisers.