

installments or from death benefits that would otherwise go to the borrower's beneficiaries.

The IRS argued that, because the Pinns never made any payments on the loans, they were in default and should be charged with COD income. The Tax Court held that because the Pinns death benefits exceeded their debts, they were not in default under the loan agreement.

The court did state that the mere existence of collateral isn't what prevented the taxpayers from having COD income; it was the fact that the collateral was sufficient to satisfy the full amount of the debt.

Contingency of the death benefits

The IRS also argued that, because the Pinns death benefits were contingent, they weren't sufficient to be a valid form of collateral. The court agreed that it was possible that at some point the plan would terminate without having to pay any death benefits.

The court also noted that this had not happened as of the tax years at issue. The decision stated that if and when the Pinns lost their death benefits, the benefits' usefulness as collateral for the loan would disappear. But that hadn't happened in the year in question, so there was no COD income.



¹ *Pinn v. Comm.*, TCM 2013-45

² IRC §61(a)(12)

³ IRC §61(a)(12); Treas. Regs. §1.61-12(a); *U.S. v. Kirby Lumber Co.* (1931) 284 US 1

⁴ IRC §108(e)(2)

This old inherited house: How is it taxed?

ESTATES: Treatment of inherited property depends on its use by heir, not by decedent.

By Richard B. Malamud, J.D., LL.M., CPA

Guest Contributor

What are the tax consequences when you inherit a decedent's principal residence? It depends on how it is used thereafter. This article will discuss four possibilities:

1. Immediate sale;
2. Moved into as a principal residence (or as a second home);
3. Temporarily rented while listed for sale; and
4. Converted into a rental property.

Immediate sale

The tax treatment follows the way the residence is used by the new owner. Generally, it is of no consequence how the house was used by the decedent. When the estate or beneficiary sells the house soon after receiving it, the tax treatment is that of a sale of an investment — the same as if one had inherited stocks or bonds.

Gain or loss is long-term capital gain or loss even if it is held for less than one year by the heir; the heir is treated as if the property were held for more than one year.¹

In most cases, it will be a loss, as an inherited residence receives a fair market value basis at the date of the decedent's death (or alternative valuation date), and there will be commissions and other expenses on the sale.²

EXAMPLE 4-2: Mom dies on June 4, 2013, when the fair market value of her home is \$350,000. As the sole heir, her son sells it on September 1, 2013, for \$355,000, but pays commissions and expenses of \$20,000. This results in a long-term capital loss of \$15,000, calculated as: \$355,000 sales price - \$350,000 basis + \$20,000 expenses.

This investment approach also applies if the house was jointly owned by the husband and wife if it is sold very soon after the death.³ If the property was community property, both the decedent's half and the survivor's half receive a fair market value basis at death.⁴

What about a delayed sale? In one case, the taxpayer simply kept the house for six years after her mother's death for appreciation purposes.⁵ The house was never rented. Occasionally, her child stayed in the house. The court disallowed deductions, finding that even though the house went up in value, such could be said of all real estate and concluded that this wasn't an activity engaged in for profit.

House used as a residence by heir

If, instead of selling, the heir moves into the house, it will either be a principal residence or a second residence. The normal tax rules for homes will apply.

If the property is acquired from a deceased spouse, the time the decedent owned and lived in the house is counted toward the two year holding period required for the IRC §121 exclusion if sold within two years.⁶

Short-term rental during attempt to sell the property

There are two rental possibilities:

- Short-term, while trying to sell the property; and
- Long-term, when the property is converted to rental.

In both cases, a loss should be allowed upon sale because the property will be considered investment property.⁷ When the property is rented simply to reduce the cost of carrying the property until sale, it is probably not treated as rental property.

As investment property, it appears that since the intent is to sell the property, expenses are allowed only as itemized deductions — the same as amounts paid to a financial advisor for investment advice. This should be a miscellaneous itemized deduction subject to the 2% floor for individuals and also for fiduciaries, unless the costs would not have been incurred if the property were not held in an estate or trust.⁸ As investment property, gain or loss should be long-term capital gain or loss.

Where a son moved into his mother's home after her death and two years later sold the house at a loss after a very short rental, the loss was disallowed as a personal loss. The court said that moving into the house had the effect of "fixing the character of the property in their hands as residential."⁹

EXAMPLE 4-3: The same house as in Example 4-2 is rented for three months for \$2,500 per month and sold for \$355,000. The \$7,500 of income should be reported, and the cost of maintenance expenses would be a miscellaneous itemized deduction.

The IRS might argue that, under IRC §183, deductions are limited to the rental income where the property is vacant for a long period of time and is then rented on a short-term basis at a loss.¹⁰ In such a case, the choice to keep the house as a personal residence, as investment property, or as rental property may not be clear and the IRS may argue therefore it is personal and not investment.

Rev. Rul. 74-28 discusses short-term rental by a tenant solely for the purpose of covering the cost of leasing the property when the tenant moved out of his apartment for health reasons.

It is not clear how soon an estate, trust, or heir has to decide how the house will be used or sold and what the tax treatment is in the interim, while it is vacant and awaiting a decision. It is also not clear whether, once the decision is made, it applies retroactively. In *Carrick*, a beneficiary lived in a house owned by a trust and sold it at a loss when it was received upon reaching majority. The court allowed the loss.¹¹

If the IRS is successful in treating the property as personal upon sale, no loss would be allowed — but gain would be taxable as long-term capital gain.

Property converted to rental

When the facts show that the property is rental property, the tax treatment is simply to report the house as rental real estate on Schedule E, with the cost being the basis obtained from the estate. It will be first-year MACRS 27.5-year property once it is placed in service as rental property.

The other usual rental issues will apply, such as:

- The allocation of the basis to land, building, and personal property;
- Whether fixing-up costs are repairs or capital expenditures;
- Passive activity issues;
- At-risk issues; and
- IRC §1231 gain or loss on sale.

Election to forego estate tax deduction for income tax deduction

In some limited situations, expenses on the sale of the decedent's personal residence can be both an administrative expense deductible on the estate tax return and a capital loss if an administrative trust sells the property.¹² Only one deduction is allowed.

Priority is given to the estate tax return, unless an irrevocable election is made to take the loss on the trust return rather than on the estate tax return. When there is no taxable estate, the election should be made.

Given the current estate tax rate of 40%, a deduction on the estate tax return will usually be preferable to using the expense to reduce capital gains on an income tax return at a maximum rate of 20% (plus state taxes). However, the deduction is only allowed on the estate tax return if the sale is necessary to pay the estate's debts, administrative expenses, or taxes, or is required to preserve the estate or to make distributions.¹³ This is not often the case.

If that isn't the case, and the IRS usually takes that position, the loss is properly taken on the income tax return. One court rejected an estate tax deduction, stating "[W]e also can discern no reason why the estate would be responsible for selling (the home) and maintaining it."¹⁴

Conclusion

The tax treatment of inherited property is fairly straightforward once it is determined how the property is being used by the estate, trust, or heir. It is that use that determines the tax treatment as if the taxpayer had bought the property rather than inherited it.

The question is, therefore, if the taxpayer *had* bought the property, how would the income, deductions, gain, or loss be reported, taking into consideration that basis and holding period are determined based on the rules applicable to inherited property?

About the author

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- ¹ IRC §1223(9)
- ² IRC §1014(a)(1)
- ³ *Watkins v. Comm.*, TCM 1973-167
- ⁴ IRC §1014(b)(6); Treas. Regs. §1.1014-2(a)(5)
- ⁵ *Ray v. Comm.*, TCM 1989-628
- ⁶ IRC §121(b)(4), (d)(2)
- ⁷ *Campbell v. Comm.* (1945) 5 TC 272
- ⁸ IRC §67(e)(1)
- ⁹ *Horrman v. Comm.* (1951) 17 TC 903
- ¹⁰ See, for example, IRC §183(b)
- ¹¹ *Carrick v. Comm.* (1947) 9 TC 756
- ¹² IRC §2053 or §2054
- ¹³ Treas. Regs. §20.2053-3(d)
- ¹⁴ *Estate of Millikin v. Comm.* (1997) 106 F3d 1263

IRS appeals loss in Registered Tax Return Preparer case

TAX: The district court decision prevents the IRS from moving forward with the RTRP program, but it does not affect the IRS requirement that practitioners have PTINs.

By Renée Rodda, J.D.

Associate Editor

The Department of Justice (DOJ) is appealing the January district court decision that prevents the IRS from enforcing the regulatory requirements for registered tax return preparers (RTRPs).¹

Although the RTRP program is currently on hold, the IRS “continues to have confidence in the scope of its authority” to administer the program, and they are working with the DOJ to address all of their options.

The ruling does not affect the PTIN requirement. Anyone who prepares or assists in preparing federal tax returns for compensation must have a valid 2013 PTIN before preparing returns. All Enrolled Agents must also have a PTIN.

Note: At this time, continuing education hours for Enrolled Agents must still be reported to the IRS by providers. Continuing education providers (Spidell Publishing, for example) will report hours to the IRS using PTINs.

What does this mean for RTRPs?

What this means for the future of this designation is unclear.

At this point there is no RTRP designation. The testing has been placed on hold, and the IRS has been enjoined from requiring preparers to obtain the designation.

This means there are currently no continuing education requirements for RTRPs or provisional RTRPs. Continuing education providers are still permitted to report hours for RTRPs who have completed their courses. However, the IRS has stated that providers must advise RTRPs that continuing education is not currently mandatory.

The IRS statements show that they have not given up on the program, but at this point they have no authority to enforce it.