FLOHOM: Tax White Paper

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Table of Contents

Introduction ______________________________________1

- Basics of Depreciation
- Overview and History of the Passive Activity Rules
- Passive Activity Limits

Tax Implication of Investing in a FLOHOM as an LP ___________________________5

- Why a FLOHOM is Treated as 10-Year Property
- Material Participation in FLOHOM as an LP
- Passive Participation in FLOHOM (passive loss harvesting opportunities through other rentals, businesses, or syndications)
- Navigating Impacts of Personal Use: knowing what pitfalls to avoid
- Tax Implications of Liquidation (depreciation recapture vs capital gains)

Reporting of a FLOHOM Investment _______12

- What to Expect to See on Your Tax Return
- Reporting the Activity on Schedule C vs Schedule E
- Is FLOHOM Income Subject to Self-Employment Tax
- Is a FLOHOM Eligible for §1031 Exchanges?

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Introduction

Basics of depreciation

Assets are required to be capitalized and depreciated over a prescribed timeline if their useful life is more than one year and there is future earning potential from the asset. In general, this means the cost of an asset is not deducted in full in the year of purchase. Depreciation is a deduction under §168 which is intended to provide for the normal wear and tear of an asset.

Annual depreciation deductions are based on the cost of the asset and its useful life as prescribed by IRS guidelines. Note: the source of financing does not affect depreciation because it does not affect the total cost basis.

While there are dozens of asset classifications, traditional real estate assets are broken down into the following categories:

- 5-Year: furniture & fixtures
- 7-Year: other assets without a specific classification
- 15-Year: land improvements and other interior improvements to non-residential property
- 27.5-Year: residential structures
- 39-Year: non-residential structures

Further, these class lives also dictate which assets are eligible for bonus depreciation. Bonus depreciation is an accelerated form a depreciation which allows a prescribed percentage of eligible assets to be deducted in the first year of ownership.

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At the time of this writing, the 2024 rate is 60% and 2025 is 40%. For example, a FLOHOM that is placed in service in 2024 for $300,000 would receive an accelerated deduction of $180,000, while the remaining $120,000 would be depreciated over ten years.

Note: the percentages applicable to bonus depreciation are updated by legislation relatively often. The last change to bonus depreciation was made September 27, 2017. Also, traditional real property requires some value to be allocated to land which is not depreciable.

Overview and history of the passive activity rules

As a rental property owner, it is not uncommon for your properties to produce a net loss for tax purposes thanks to depreciation and other operating expenses.

Prior to 1986, taxpayers could deduct losses related to their rental activities in full against their other income regardless of their level of participation. This allowed high-income earners to shelter their wages and business income with non-economic losses from real estate.

In an effort to curb this benefit for wealthy taxpayers, Congress passed the Tax Reform Act of 1986 adding IRC §469 which eliminated this tax shelter for landlords. IRC §469 limits the taxpayer's ability to deduct losses from rental activities and other businesses in which he or she does not materially participate, from other non-passive income sources.

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As a result, a taxpayer can only use passive losses generated from rental activities to offset the taxpayer's passive income (IRC §469(d)(1)). Later in 1994, §469 was amended to include a caveat to this limit for taxpayers who qualify for Real Estate Professional Status (REPS). Qualification requires a taxpayer to spend at least 750 hours in real property trades or businesses and material participate in their rental properties.

Barring the exception for REPS, losses from rental property are considered passive losses and can generally offset passive income only (that is, income from other rental properties or another business in which you do not materially participate, not including investments).

If these passive losses exceed your passive income, they are suspended and carried forward indefinitely until future years, when you either have passive income or sell a property at a gain.

This is good news because a net loss (for tax purposes) means you are not paying taxes on your rental income today, even if you have positive cash flow.

Additionally, passive losses can offset your ordinary income from a W-2 job or another trade or business if the circumstance discussed below applies.

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Passive Activity Limits

Under the passive activity rules, you can deduct up to $25,000 in rental passive losses against your ordinary income (W-2 wages) if your modified adjusted gross income (MAGI) is $100,000 or less. These thresholds apply for both single and married filing joint taxpayers.

This deduction phases out $1 for every $2 of MAGI above $100,000 until $150,000 when it is completely phased out. These limits apply to both those filing single or married filing joint.

To take losses against your ordinary income, you must demonstrate **active** participation in the activity. This is less stringent than the material participation requirement for real estate professionals and generally means you play a role in making management decisions for the business.

Example

Your MAGI is $100,000 for the year and your rental properties produce a net loss of $30,000. As long as you actively participate in your rental activities, you'll be able to deduct $25,000 of this loss against your ordinary income. The remaining $5,000 will be carried forward.

However, if your MAGI was $125,000, in this case, you can deduct only $12,500 of the loss because each dollar over $100,000 reduced the amount you could deduct by $0.50. If your MAGI was over $150,000 then you cannot deduct any of these losses against your ordinary income and the entire $30,000 is carried forward.

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Tax Implications of Investing in a FLOHOM as an LP

Why a FLOHOM is treated as 10-year property

Revenue Procedure 87-56 identifies the various class lives of fixed assets. Class 00.28 is defined as vessels (e.g., yachts), barges, tugs, and similar means of water transportation, but not used in marine construction or as a fishing vessel and is assigned a 10-year class life.

This 10-year class life is uniquely advantageous because bonus depreciation only applies to assets with a class life of 20 years or less. For example, a single-family home with comparable purchase price, would produce roughly one fourth as much bonus depreciation in the first year and roughly one third as much straight line depreciation in the first 10 years.

Treasury Regulation § 1.856-10(b) defines real property to be land and improvements to land. Subsection (d) then expands on this by stating improvements to land means inherently permanent structures and their structural components.

In paragraph (2): The term inherently permanent structure means any permanently affixed building or other permanently affixed structure. Affixation may be to land or to another inherently permanent structure and may be by weight alone. If the affixation is reasonably expected to last indefinitely based on all the facts and circumstances, the affixation is considered permanent.

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Therefore, we first need to examine how the FLOHOM is attached to the dock. Docks are generally considered inherently permanent structures, in most cases. So if the FLOHOM is permanently affixed or is reasonably expected to be indefinite, then it would be treated as real property. However, simply attaching a mooring line is not indefinite.

It can be further examined through the definition of "affixation" which is further discussed under Treasury Regulation §1.856-10(d)(2)(iv) and considers five main facts and circumstances:

(1) The manner in which the distinct asset is affixed to real property;
(2) Whether the distinct asset is designed to be removed or to remain in place indefinitely;
(3) The damage that removal of the distinct asset would cause to the item itself or to the real property to which it is affixed;
(4) Any circumstances that suggest the expected period of affixation is not indefinite (for example, a lease that requires or permits removal of the distinct asset upon the expiration of the lease); and
(5) The time and expense required to move the distinct asset

In summary, because the FLOHOM is not affixed to real property, it does not need to remain in the same location, no damage would occur to the home when moving it, the effort and expense to move it is minimal, and generally the lease of a dock slip is not indefinite, the property does not meet any of the five main factors considered to established affixation. Thus, it can't be considered real property, but rather a vessel under the Class 00.28.

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Material participation in FLOHOM as an LP

There are seven material participation tests in the treasury regulations under §1.469-5T(a). The most common three tests considered for rental activities are:

1) The individual's participation in the activity for the taxable year constitutes substantially all of the participation in such activity of all individuals (including individuals who are not owners of interests in the activity) for such year
2) The individual participates in the activity for more than 100 hours during the taxable year, and such individual's participation in the activity for the taxable year is not less than the participation in the activity of any other individual (including individuals who are not owners of interests in the activity) for such year
3) The individual participates in the activity for more than 500 hours during such year

We'll refer to these tests as the "substantially all", "100-hour", and "500-hour" tests respectively.

By default, participation as a limited partner in a FLOHOM investment will preclude you from claiming any of the above material participation tests. This will deem the activity to be passive.

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Passive participation in FLOHOM (passive loss harvesting opportunities through other rentals, businesses, or syndications)

As mentioned in the above sections, depreciation benefits will in most cases produce a tax loss on your FLOHOM. If you are not meeting one of the aforementioned material participation tests, these losses will be treated as passive.

While an investor can still take advantage of the passive loss carryforward provisions mentioned in the overview of passive activity rules section above, there are additional options to harvest these losses in the current year.

For example, rental real estate is passive by default. So, if you have income producing real estate, whether that is assets you wholly own or through limited interests in syndications, passive losses from a FLOHOM could absorb that income.

Further, you can invest in other passive income generating businesses outside of rentals. Other business interests outside of rental activities can also be passive, provided you don't materially participate in their operations.

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Navigating impacts of personal use: knowing what pitfalls to avoid

If your FLOHOM is used on a transient basis, i.e. rented on a nightly basis, you will have the opportunity to stay at the home yourself. This is permissible, however, there are negative tax impacts that are important to be aware of before deciding to use your property.

Personal use limitations are outlined under IRC §280A.

Specifically, §280A(c)(5) explains the deductions allowable will be limited to gross income if the "dwelling unit is used by the taxpayer during the tax year as a residence". The definition of a "residence" under subsection (d) is the greater of 14 days or 10% of days rented. Put in more plain English, this means that if you stay at your property for the larger of either 14 days or 10% of the days it's rented to third parties, your deduction can't exceed rents collected.

Keep in mind, even if you stay below this 14 day or 10% threshold, subsection (e) still enforces a proration of deductions by taking personal days divided by the total days used.

Consider the following examples:

Your FLOHOM is rented for 135 days and you stay for 15 days. Under subsection (c), your deductions would be limited to rents collected. This is because 15 is greater than both 14 and 10% of the days rented (135 x 10% = 13.5).

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Now let’s assume you rent your FLOHOM for 165 days with the same personal use of 15 days. Your deductions would be permitted to exceed rent collected and generate a tax loss.

This is because the personal use of 15 days is now below the 10% of days rented (16.5). However, the deductions that can be claimed will still be reduced by subsection (d) by 12% (15 personal days divided by 180 total days used).

Strategically, these limitations have the greatest impact in the first year when bonus depreciation would be applicable.

Because depreciation will be substantially lower in subsequent tax years, personal use will have a smaller impact. It is recommended you discuss these potential impacts to your deduction with your tax advisor in any year you plan to use the property personally.

Note: §280A(d)(2) includes the use by your immediate family as personal use, regardless of whether they pay fair market value rent. According to §267(c)(4) family members include “brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants”.

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Tax implications of liquidation (depreciation recapture vs capital gains)

Anytime an asset is sold, you may recognize several forms of income. First, the most preferential form, is Long-Term Capital Gains (LTCG). LTCG sale minus purchase, preferential rates as of 2024 are as follows:

Single	Married Filing Joint	Tax Rate
47,025	94,050	0%
518,900	583,750	15%
518,901+	583,751+	20%

Depreciation recapture is the second category. With traditional real estate, as mentioned above, there are typically various class lives associated with an asset which can produce differing tax rates.

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However, because a FLOHOM is 100% categorized as 10-year §1245 property, the depreciation recapture is more straightforward. Per §1245(a)(1), if you sell §1245 property for more than your adjusted basis, then the recapture is recognized as ordinary income. This means the depreciation recapture will be taxed using your marginal tax rate (i.e. up to 37%).

For example, assume you purchase your FLOHOM for $400,000 and, over a few years, have taken depreciation totaling $300,000. Then you plan to sell it for $650,000. This would result in a $250,000 Long-Term Capital Gains (LTCG) and $300,000 of depreciation recapture.

Reporting of a FLOHOM Investment

What to expect to see on your tax return

If you are passive in your FLOHOM, you should see the net profit or loss flow to the Form 8582 where passive income and losses are aggregated to determine if the losses may be utilized (i.e. offset other passive income or loss).

When your FLOHOM produces net taxable income in a future year, the prior year(s) losses will be shown as a prior year carryforward and offset the income. In effect, this can shield multiple years' profits from taxation until all the passive losses have been consumed.

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Reporting the activity on Schedule C vs Schedule E

Generally, rental real estate is reported on a Schedule E (Supplemental Income and Loss) and the rental of personal property is reported on a Schedule C (Profit or Loss From Business).

It is a common misconception that because property such as boats or recreational vehicles are used as a dwelling unit, that they should be treated as the rental of real property.

This stems from §280A(f) which states the term "dwelling unit" includes a house, apartment, condominium, mobile home, boat, or similar property, and all structures or other property appurtenant to such dwelling unit. This is conclusive that the personal use limitations apply to boats and floating dwelling units.

However, as noted above, 280A applies the limitations to the deductions allowable for property which is used personally. This is not to be construed as a rationale to claim property as real property.

Therefore, we must look further to the definition of real vs personal property to determine which form to use. As previously noted in the Why is a FLOHOM treated as 10-year property section, the FLOHOM is not a building, structure, or land improvement due to its lack of permanence and affixation to a permanent structure.

As such, it must be treated as the rental of personal property and reported on a Schedule C.

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Is FLOHOM income subject to Self-Employment tax?

Section 1402(a) of the IRC defines "net earnings from self-employment" as the gross income derived by an individual from any trade or business carried on by such individual, less the deductions attributable to such trade or business.

An individual is generally considered to be engaged in a trade or business if he or she is regularly and continuously engaged in an activity, the primary purpose of which is to realize an income or profit.

An exception to this rule is outlined under §1402(a)(1) which excludes income from the “real estate and from personal property leased with the real estate”. However, as previously noted above, a FLOHOM is not classified as real property.

We must then, consider what level activity rises to being “engaged in a trade or business”. while this term is referenced in over 850 sections and subsections of code as well as hundreds of income tax regulations, it has never been clearly defined. As noted in a supreme court case from 1987 (Commissioner of Internal Revenue, Petitioner v. Robert P. Groetzinger), all the facts and circumstances must be examined.

It's important to understand that an activity can be passive and therefore subject to limitations under §469 while still being subject to self-employment tax.

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Generally, merely making investments does not rise to the level of a trade or business. But, if you are regularly and continuously engaged in an activity for profit, those profits would be subject to self-employment taxes. This could include assisting with high-level operational decisions such as repairs & maintenance, insurance, reviewing financials, and managing debt related to the asset.

Is a FLOHOM eligible for §1031 exchanges?

§1031(a)(1) states that "no gain or loss shall be recognized on the exchange of real property held for productive use in a trade or business or for investment if such real property is exchanged solely for real property of like kind which is to be held either for productive use in a trade or business or for investment."

As noted in the above sections, while a FLOHOM is a rental activity, it is not considered to be real property, most notably under Treasury Regulation §1.856-10. Therefore, it is ineligible for a §1031 exchange.

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