



C. Forrest Davis, E.A.

Since 1986 • Enrolled Agent

4402 E. Brott St. • Tucson, AZ 85712

(520) 322-9147 • www.davis-tax.com

e-mail: forrest@davis-tax.com

The "Other" Tax Aspects of Real Estate

1. Real estate property tax
2. Property tax exemptions:
 - widow/disability
 - senior tax freeze
 - tax deferral
3. Residential rental property registration
4. Self-rental
5. Historic properties tax reduction
6. Beneficiary deeds

Helpful resources:

- ADOR property tax forms:
<http://www.revenue.state.az.us/Forms/property.asp>
- Pima County Assessor forms:
<http://www.asr.pima.gov/ASRT/HTML/pservice/pservice.htm>
- Yavapai County Assessor's Office FAQ:
<http://www.co.yavapai.az.us/FAQ.aspx>
- Property tax relief summary (Paul Bartlett, atty):
<http://www.tucsonelderlaw.com/Arizona-Property-Tax.htm>
- Keyt Law (Phoenix):
<http://www.keytlaw.com/>

*presented to
Southern Arizona Chapter of Enrolled Agents
Sept. 19, 2006*

Widow's Property Tax Exemption

What are property tax exemptions?

Arizona provides property tax exemptions, in varying dollar amounts, to qualifying disabled persons and widows/widowers, whose spouses passed away while residing in Arizona.

Remember, the last business day in February is the deadline to file for any property tax exemption.

Who is entitled to an exemption?

Exemptions are available for qualifying widows, widowers and totally disabled persons.

What is a disability exemption?

In order to qualify for the property tax exemption for disabled persons, a person must be totally and permanently disabled, either physically or mentally, resulting in that person's inability to engage in any substantial gainful activity.

If I qualify, what are the benefits?

The Assessed Value of the property will be reduced by no more than \$3,076.00, thereby corresponding to a reduction in your property tax bill.

Is the exemption for my house only?

No, the exemption is applied to real estate first, then to a mobile home or automobile.

What are the qualifications?

1. You must be a resident of Arizona.
2. Your Total Assessed Valuation (see definition above) in Arizona cannot exceed \$20,905. This means the property assessment usually equates to a 209,050 property valuation.
3. Household income from all sources, excluding social security, cannot exceed \$25,637.
4. If children under 18 years of age reside in the household, income cannot exceed \$30,764.
5. Disability must be total, permanent and certified by an Arizona licensed physician on form DOR 82514B. A certificate is only needed for a new application (unless requested by our office).

When and where do I apply?

You must file an application between January 1 and the last business day in February in one of the two Yavapai County Assessor's Offices. Arizona State Statutes require first time applicants to apply in person. After qualifying for an exemption you will no longer need to fill out exemption paperwork on a yearly basis. However, owners must notify the Assessor of any changes that apply to the eligibility of the exemption.

<http://www.co.yavapai.az.us/FAQ.aspx?mk=FAQCategories&mv=+Exemptions&id=17652>



2006 Seniors' Property Valuation Protection
We will be accepting applications January 2nd through September 1, 2006
(Revised 10-28-05)

HCR #2038: Valuation Freeze for Seniors' was approved by the voters of the State of Arizona in the general election November 7, 2000. The program became effective for tax year 2001. In November 2002, a revision was voter approved regarding application deadline and income limits as adjusted below.

BENEFIT: To Freeze the **Full Cash Value** of your Primary Residence.

It is important to understand, should you qualify for the program your **TAXES** are **NOT** frozen.

The freeze applies only to the **FULL CASH VALUE** of your property and will remain frozen even in the event of a declining real estate market. Any changes to the property such as new construction or demolitions will change your **FULL CASH VALUE**.

Until your limited value reaches the amount of your full cash value, your taxes may increase. In addition, if your tax rates increase your taxes will also increase.

Qualifications for Seniors' Property Valuation Protection

1. **AGE:** At least one property owner must be the minimum qualifying age of 65 at the time of application.
2. **RESIDENCE:** The property must be the owner(s) primary residence. A "primary" residence is that residence which is occupied by the property owner(s) for an aggregate of nine months of the calendar year. A qualified owner can have only one primary residence and must have resided in the residence for two years at the time of application. This protection includes up to ten acres of land including the primary residence identified by one parcel number.
3. **OWNERSHIP:** If the property is held in trust, provide proof of trustees along with the application to determine ownership eligibility. Any change in ownership may result in the loss of the Freeze.
4. **INCOME LIMIT:** All gross income, taxable and non-taxable, of all owners will be used to determine eligibility. This income must be verified for three years prior to the year in which the freeze becomes effective (2003, 2004, 2005). Total **three-year average** income cannot exceed the following limits:

\$28,944 – One Owner
\$36,180 – Two Or More Owners

5. **INCOME VERIFICATION:** When applying for property valuation protection, documentation to verify all **gross income**, residency and age must be submitted with the application. Applications must be submitted in person to the Assessor's office; **no applications by mail will be accepted**. The list below offers examples of acceptable income verification forms.

- | | | |
|--|--------------------------------|---------------------------|
| ● Federal Income Tax Return | ● Social Security Benefits | ● Wages/Salaries/Tips |
| ● Dividends & Interest | ● Capital Gains/IRA Income | ● Disability Compensation |
| ● Business/Farm Income | ● Rent & Royalty Income | ● Railroad Retirement |
| ● Veteran Disability Pension Insurance | ● Workman's Compensation | ● AZ Unemployment |
| ● Alimony/Welfare Payments | ● Retirement/Pension & Annuity | |

6. **REQUALIFICATION:** Once qualified, the freeze is in effect for a three-year period, unless otherwise indicated by law. The Assessor will notify the property owner(s) six months prior to the expiration of the current period; reminding them they must re-qualify for the protection to continue.

OVER FOR CHECKLIST



SENIOR PROPERTY VALUATION PROTECTION OPTION

INITIAL APPLICATION

NOTICE OF REAPPLICATION

APPLICANT: Please read the instructions on the reverse side before completing this form. Complete the form and copy for your records before submitting it to the County Assessor where your primary residence is located. The form must be submitted by September 1.

Application Date _____ County _____ Book _____ Map _____ Parcel _____

Applicant's Name(s) _____

Primary Residence Address _____ City _____ Zip _____

Years lived in primary residence _____ (must be minimum of two years). Provide proof of residency by submitting utility statements, voter registration, or other documentation of proof as requested by the Assessor.

NOTE: "Primary residence" is defined as that residence which is occupied by the taxpayer for an aggregate of nine months of the calendar year. A qualified taxpayer can have only one primary residence.

Are you the sole owner? Yes No If co-owned, please state total number of owners _____

At least one of the owners must be sixty-five years old. Provide proof of age (birth certificate, driver's license, passport, etc.).

Qualified Owner's date of birth: ____/____/____

INCOME INFORMATION: List total annual income for all owners from all sources, taxable and non taxable, for the previous three calendar years. Documentation may be requested by the Assessor to verify income.			
INCOME FROM ALL SOURCES	Year One _____	Year Two _____	Year Three _____
Salaries, wages, and tips earned.	\$	\$	\$
Social Security benefits received.			
Pension and annuity income received.			
Dividend and interest income received.			
Rent and royalty income received.			
Business and farm income received.			
Unemployment insurance payments received.			
Workmen's compensation payments received.			
Railroad retirement benefits received.			
Veteran's disability pension payments received.			
Alimony payments received.			
Estate and trust income received.			
Welfare payments received.			
Other income earned or received.			
TOTAL ANNUAL COMBINED INCOME =	\$	\$	\$

Three Year Total Annual Combined Income \$ _____ Three Year Average \$ _____

Under penalty of perjury, I hereby certify that all of the information contained in this application form is true and correct. I consent to the freezing of the full cash value of my primary residence for a three year period.

Print Name _____ Phone _____

Signature _____ Date _____

THIS BLOCK IS FOR COUNTY ASSESSOR USE ONLY

Residency/Age/Income Requirements Met? Yes No Valuation Freeze Approved Yes No

Amount of Three Year Average Income Verified \$ _____ Assessor/Deputy _____ Date _____

Valuation Protection Option applied to valuation years _____, _____ and _____.

INSTRUCTIONS SENIOR PROPERTY VALUATION PROTECTION OPTION

Arizona voters approved Proposition 104 in the November, 2000 General Election, and Proposition 102 in the November, 2002 General Election, thereby amending the Arizona Constitution. The Amendments provide for the “freezing” of the valuation of the primary residence of those seniors who meet all of the following requirements:

1. At least one of the owners must be sixty-five years of age at the time the application is filed. A copy of proof of age must be submitted.
2. The property must be the primary residence of the taxpayer. For purposes of this application “Primary Residence” is defined as the residence which is occupied by the taxpayer for an aggregate of nine months of the calendar year.
3. The owner must have resided in the primary residence for at least two years prior to applying for the option.
4. The owner(s) total income from all sources, including non taxable income, cannot exceed the amount specified by law.

For an initial valuation protection option application, if the owner meets all of these requirements and the County Assessor approves the application, the valuation of the primary residence will remain fixed for a three year period.

To remain eligible, the owner is required to renew the valuation protection option during the last six months of the three year period on receipt of a notice of reapplication from the County Assessor.

The freeze terminates if the owner sells the home or otherwise becomes ineligible. The property’s valuation will revert to its current full cash value as determined by the County Assessor in the valuation year in which the sale is completed.

Please be aware that, while the VALUATION will be frozen for as long as the owner remains eligible, TAXES for the primary residence will **NOT** be frozen and will continue to be levied at the same rate that is applicable to all other properties in the taxing district.

Residential Property Tax Deferral

Arizona Revised Statutes 42-17301 through 42-17313 allow qualifying property owners to defer payment of property taxes. To qualify for the deferral both the property and the property owner(s) must meet specific requirements. A claim for deferral may be filed with the Assessor's office after January 1, but before April 1 of the tax year for which the deferral is claimed.

A TAX DEFERRAL IS NOT TAX FORGIVENESS

Qualifications for the Residence

A.R.S. 42-17301 defines residence to mean "real and personal property and improvements that constitute an owner-occupied dwelling that is classified as Class 3 pursuant to section 42-12003." To qualify the residence must meet all the following requirements:

- It must be the taxpayer's primary residence.
- It must not be income producing.
- It may not have a full cash value which exceeds \$150,000.
- It must not be subject to a mortgage less than 5 years old.
- All property taxes due for preceding years must be paid.

Qualifications for the Property Owner

To qualify for tax deferral the individual must meet all the following requirements:

- Be at least 70 years of age.
- Shall own or be purchasing the residence under a recorded instrument of sale.
- Have lived in the current residence for 6 years, or lived in Arizona for the preceding 10 years.
 - May not own, or have beneficial interest in other real property.
 - In the case of a married couple, both spouses shall meet all requirements.
 - The total Arizona taxable income of all persons residing in the residence for the taxable year immediately preceding the current year (year of the filing) may not exceed \$10,000.

To apply for a deferral you must complete a "Claim for Deferral" form available in the Assessor's office. The form must be accompanied by documentation supporting the above criteria. All information must be filed with the Assessor before April 1 of the tax year for which the deferral is claimed.

Deferrals are granted for one year at a time. A new claim must be filed for each subsequent year.

Remember a tax deferral is not tax forgiveness. The deferral only postpones the payment of taxes to some future date. All deferred taxes, accrued interest and costs become due and payable if the claimant dies, ownership of the residence is transferred or the property is no longer the residence of the claimant.

NOTIFICATION OF ARIZONA RESIDENTIAL RENTAL PROPERTY

Pursuant to A.R.S. §§ 33-1901 and 33-1902 (see reverse side)

INSTRUCTIONS: In compliance with A.R.S. § 33-1902(A): an owner of residential rental property shall maintain with the Assessor in the county where the property is located information required by this section in a manner to be determined by the Assessor. If the property is owned by a corporation, limited liability company, partnership, limited partnership, trust or real estate investment trust, include the name, address and telephone number of the business entity and the statutory agent, if applicable.

Pursuant to A.R.S. § 33-1902(B): an out-of-state owner of residential rental property shall designate and record with the County Assessor a statutory agent who lives in this state and who will accept legal service on behalf of the owner. A person who fails to comply with any provision of this section shall be assessed a civil penalty of one thousand dollars, plus an additional one hundred dollars for each month after the date of the original violation until compliance occurs.

Retain a copy of this completed form for your records.

1. PROPERTY INFORMATION:

List County where property is located (required): _____

Check property type: Single Family Residence Multiple Family Residence Mobile Home MH/RV Park space

Property Site Address: _____

Street # _____ Street Direction _____ Street Name _____ Street Type (Ave, Lane, etc.) _____ Suffix (if any) _____
City/Town: _____ Zip Code: _____

List the year the building was built: _____

Parcel Number: _____

List Additional Parcel Numbers for this property (up to four):

For Unsecured Mobile Homes ONLY

List Tax Roll # _____

ATTACH LIST FOR ANY ADDITIONAL PARCELS

2. OWNERSHIP INFORMATION: (Please Print)

Check below to indicate form of ownership (Property Owner OR Business Entity):

Property owner, list name of owner: _____
Last Name _____ First Name _____

Street Address: (no P.O. Box) _____

City/State: _____ Zip Code: _____ Telephone # () _____

List the name of the business entity: _____

Street Address: (no P.O. Box) _____

City/State: _____ Zip Code: _____ Telephone # () _____

If the business entity is a:

Corporation, list name of corporate officer: _____

Limited liability company, list name of managing or administrative member: _____

Partnership, list name of general partner: _____

Limited partnership, list name of general partner: _____

Trust, list name of trustee: _____

Real estate investment trust, list name of general partner or officer: _____

3. OUT-OF-STATE OWNER'S DESIGNATION OF AGENT:

A.R.S. §33-1902(B) requires that if the owner listed above lives out of state, that a statutory agent is designated who resides in Arizona to accept legal service on behalf of the owner of residential rental property.

Name of statutory agent: _____ Address: _____

City: _____ AZ Zip Code: _____ Telephone # () _____

4. REQUIREMENT TO UPDATE INFORMATION:

Under penalty of law the owner of Arizona residential rental property shall update any information listed above within ten days after a change in the information occurs.

I request that the Assessor update the following information: Mailing Address Legal Class

I hereby affirm that the information included or attached is true and correct.

X

Signature of Property Owner or Business Entity's Representative

Date

CHAPTER 17 RESIDENTIAL RENTAL PROPERTY ARTICLE 1. GENERAL PROVISIONS

33-1901. Definitions

- A. In this article, unless the context otherwise requires: / “Managing Agent” means a person, corporation, partnership or limited liability company that is authorized by the owner to operate and manage the property.
- / “Residential Rental Property” means property that is used solely as leased or rented property for residential purposes. If the property is a space rental mobile home park or a recreational vehicle park, “Residential Rental Property” includes the rental space that is leased or rented by the owner of that rental space but does not include the mobile home or recreational vehicle that serves as the actual dwelling if the dwelling is owned and occupied by the tenant of the rental space and not by the owner of the rental space.
- / “Slum Property” means residential rental property that has deteriorated or is in a state of disrepair and that manifests one or more of the following conditions that are a danger to the health or safety of the public:
- (a) Structurally unsound exterior surfaces, roof, walls, doors, floors, stairwells, porches or railings.
 - (b) Lack of potable water, adequate sanitation, facilities, adequate water or waste pipe connections.
 - (c) Hazardous electrical systems or gas connections.
 - (d) Lack of safe, rapid egress.
 - (e) Accumulation of human or animal waste, medical or biological waste, gaseous or combustible materials, dangerous or corrosive liquids, flammable or explosive materials or drug paraphernalia.

33-1902. Residential rental property; recording with the assessor; agent designation; civil penalty.

- A. An owner of residential rental property shall maintain with the assessor in the county where the property is located information required by this section in a manner to be determined by the assessor. The owner shall update any information required by this section within ten days after a change in the information occurs. The following information shall be maintained:
1. 1. The name, address and telephone number of the property owner.
 - .2. If the property is owned by a corporation, limited liability company, partnership, limited partnership, trust or real estate investment trust, the name, address and telephone number of the statutory agent, if applicable, and the following:
 - .(a) For a corporation, a corporate officer.
 - .(b) For a partnership, a general partner.
 - .(c) For a limited liability company, the managing or administrative member.
 - .(d) For a limited partnership, a general partner.
 - .(e) For a trust, a trustee.
 - .(f) For real estate investment trust, a general partner or an officer.
 2. 3. The street address and parcel number of the property.
 3. 4. The year the building was built.
- B. An owner of residential rental property who lives outside this state shall designate and record with the assessor a statutory agent who lives in this state and who will accept legal service on behalf of the owner. The owner shall designate the agent in a manner to be determined by the assessor. The information shall include the name, address and telephone number of the agent.
- C. Residential rental property shall not be occupied if the information required by this section is not on file with the county assessor. This subsection does not affect any existing lease.
- D. All records, files and documents that are required by this section are public records.
- E. A person who fails to comply with any provision of this section shall be assessed a civil penalty of one thousand dollars, plus an additional one hundred dollars for each month after the date of the original violation until compliance occurs. The court shall not suspend any portion of the civil penalty provided by this subsection.
- F. Notwithstanding subsection E of this section, if a person complies within ten days after receiving the complaint that notices the violation, the court shall dismiss the complaint and shall not impose a civil penalty.
- G. In carrying out the provisions of this section the county assessor shall have immunity as provided in Section 12-820.01.

Return completed form to:

**Pima County Assessor
Attn: Gerry Huff
115 N. Church Ave.
Tucson AZ 85701**

Historic Properties SPT Program

Administered by the National Park Service, This program aids owners who rehabilitate underutilized historic commercial or industrial properties by offering participants a substantial reduction in their annual state property taxes. The intent of this program is to provide an owner the opportunity to make a building presentable to tenants and allow such tenants a period to establish business without the burden of increased rent due to property tax increases.

Who should apply?

Any business who owns or plans to buy a historic property

Benefits of the Program

A temporary tax classification that allows for modifications that are intended to restore or rehabilitate the property are almost entirely tax -free (assessed at 1% of full cash value rather than 25%). The temporary classification set by the county assessor does not necessarily change the current base assessment during the length of the agreement

Important Dates

- Gather information about proposed rehabilitation and costs in advance
- SHPO must approve plans for such work prior to implementation. Applications can be obtained from your county assessor's office or the SHPO. Completed applications must be mailed to the county assessor's office along with two 5" x 7" color photos of the property's exterior.

SHPO: State Historic Preservation Office, Az State Parks Dept

Program Requirements

- The property owner must rehabilitate and maintain the property to preserve the historical integrity of its features, materials, appearance, workmanship, and environment.
- The property owner enters into a 10-year agreement
- During this agreement all construction, rehabilitation and maintenance work must conform to the Secretary of the Interior's Standards for Rehabilitation
- The property owner may be required to annually submit an expenditure record, and a form (furnished by the SHPO) verifying that the property has been maintained according to program guidelines

Limitations

- Applicants will receive notice within six weeks of application submittal.
- For commercial properties, the tax reclassification takes effect immediately.

Next Steps/Contact Info

- Visit www.pr.state.az.us/partnerships/shpo/taxincen.html or call (602) 542-4009 for more information
- View the Secretary of the Interior's Standards for Rehabilitation, accessible at <http://www.pr.state.az.us/partnerships/shpo/spt/standards.pdf>
- Search for Registered Properties at www.cr.nps.gov/NR/research/nris.htm

S Corporation Shareholder's Use of Home

The Tax Book, TY2005 edition
Page 19-11

If the general requirements are met, a shareholder is allowed to deduct expenses for business use of the home assuming the shareholder receives reasonable wages for services rendered. Such expenses are deducted as employee business expenses on Schedule A of Form 1040, subject to the 2% of AGI limitation.

Exception for rental. A taxpayer is not allowed to deduct expenses for business use of the home attributable to rent paid by the employer if the employee is providing services. The employer is allowed a deduction for rent paid, but the employee is not allowed a deduction for business use of the home. [IRC 280A(c)(6)]

Example 1: Bart is a shareholder in Caution, Inc., an S Corporation. The corporation pays Bart \$3,600 during the year for use of a portion of Bart's residence. Bart performs services for the corporation in the business use portion of his residence.

Caution, Inc., deducts rent in the amount of \$3,600. However, even though Bart's business use of his residence would otherwise qualify for a deduction, because of the exception under Section 280A, he is not allowed to deduct the expenses. Bart must report the \$3,600 as rental income on his tax return.

IRC 280A

(a) General rule

Except as otherwise provided in this section, in the case of a taxpayer who is an individual or an S corporation, no deduction otherwise allowable under this chapter shall be allowed with respect to the use of a dwelling unit which is used by the taxpayer during the taxable year as a residence.

(c) Exceptions for certain business or rental use; limitation on deductions for such use

(1) Certain business use

Subsection (a) shall not apply to any item to the extent such item is allocable to a portion of the dwelling unit which is exclusively used on a regular basis—

(A) as the principal place of business for any trade or business of the taxpayer,

(B) as a place of business which is used by patients, clients, or customers in meeting or dealing with the taxpayer in the normal course of his trade or business, or

(C) in the case of a separate structure which is not attached to the dwelling unit, in connection with the taxpayer's trade or business.

In the case of an employee, the preceding sentence shall apply only if the exclusive use referred to in the preceding sentence is for the convenience of his employer. For purposes of subparagraph (A), the term "principal place of business" includes a place of business which is used by the taxpayer for the administrative or management activities of any trade or business of the taxpayer if there is no other fixed location of such trade or business where the taxpayer conducts substantial administrative or management activities of such trade or business.

(3) Rental use

Subsection (a) shall not apply to any item which is attributable to the rental of the dwelling unit or portion thereof (determined after the application of subsection (e)).

(6) Treatment of rental to employer

Paragraphs (1) and (3) shall not apply to any item which is attributable to the rental of the dwelling unit (or any portion thereof) by the taxpayer to his employer during any period in which the taxpayer uses the dwelling unit (or portion) in performing services as an employee of the employer.

7-26

- b. The rental property provides lodging for the taxpayer's employees for his convenience.

Example 7-19: Rental incidental to an investment activity.

Harry owns 1,000 acres of unimproved land with an FMV of \$350,000 and an unadjusted basis of \$210,000. His principal purpose for holding the land is to realize gain from appreciation. To defray the cost of carrying the land, Harry leases it to a rancher who uses it to graze cattle and pays rent of \$4,000 per year. Thus, the gross rental income from the land is less than 2% of the lesser of the FMV or the unadjusted basis ($.02 \times \$210,000 = \$4,200$). Accordingly, the rental of the land is *not* a rental activity because the rental is incidental to an investment activity. The \$4,000 of income is treated as portfolio income rather than rental income for Section 469 purposes. Any expenses associated with the land lease activity would be deductible by Harry as investment expenses (miscellaneous itemized deductions subject to the 2% of AGI floor).

Rent Income Recharacterization under the Passive Activity Rules

705.9 The regulations in Temp. Reg. 1.469-2T(f) contain several situations in which income from rental real estate activities is recharacterized from passive to nonpassive income. These provisions limit a taxpayer's ability to generate passive income to offset passive losses. These rules only have the effect of recharacterizing passive income as nonpassive. They do not have the same effect on passive losses. (However, see "Note" at paragraph 705.10.) The IRS is in a "win/win" situation on these activities because net losses remain passive while net income is recharacterized as nonpassive.

705.10 **Note:** Taxpayers can choose to group a trade or business activity with a rental activity as one activity, provided certain requirements are met. This can effectively allow a passive rental loss to be utilized against nonpassive business income. The passive loss is not recharacterized as nonpassive; it is simply combined with the nonpassive activity as one activity. See Reg. 1.469-4(d)(1) and *PPC's 1040 Deskbook*, Key Issue 16A, for further discussion.

705.11 **Self-rented Property.** The self-rented property recharacterization rule affects taxpayers who rent property to a trade or business in which they materially participate. This includes trade or business activities conducted through partnerships, S corporations, and C corporations. Here, losses from the rental are passive, but the gross rental income equal to the net rental activity income from the property for the year is recharacterized as nonpassive income [Reg. 1.469-2(f)(6)]. This rule does not apply if the property is rented incidental to a development activity [Reg. 1.469-11(c)(1)(ii)].

Example 7-20: Self-rented property.

Joe owns all of the stock of Joecorp, an S corporation in which he materially participates. He rents a building that he owns individually to the corporation beginning in March and incurs expenses of \$20,000 from the property for the year. The gross rental income is \$25,000. The \$20,000 of expenses are deductible up to the income from the rental; the remaining \$5,000 of income is recharacterized as nonpassive.

705.12 For this recharacterization rule, the "gross rental activity income" for a tax year includes any passive activity gross income, determined without regard to the recharacterization rules, that is income for the year from the rental or disposition of the property [Reg. 1.469-2(f)(9)(iii)].

705.13 **Note:** Self-rented property is treated as a nonpassive activity if it produces net income but a passive activity if a net loss results. Thus, a taxpayer could end up with a suspended passive loss for the activity if it produces a net loss over a period of years. Under the "former passive activity" rules, however, an activity with suspended passive losses that later is treated as a nonpassive activity can utilize the suspended losses against the activity's nonpassive net income [IRC Sec. 469(f)(1)]. In other words, the recharacterization rules only prevent taxpayers from using income from self-rented property to absorb losses from other passive activities. It does not prevent taxpayers from offsetting income and losses from such property against each other, regardless of when generated.

TIN 4/06

7-27

705.14 **Caution:** Recharacterization cannot be avoided by combining a self-rental activity generating income with other rental activities that generate passive losses as a single economic unit (See discussion beginning at paragraph 704.11). The self-rental activity is removed from the passive loss calculation before any grouping is considered (*Carlos*).

705.15 **Rental to C Corporations.** The final passive loss regulations do not specifically address whether the recharacterization rules apply to a taxpayer renting property to a C corporation. (Temporary regulations supported passive income treatment of net income from such rentals for tax years beginning before May 11, 1992.) However, the final regulations do state that a taxpayer's activities include those conducted through C corporations subject to IRC Sec. 469 (i.e., closely held and personal service corporations [Reg. 1.469-4(a)]).

705.16 The Tax Court has held that the IRS intended to apply the self-rental rule to a taxpayer renting property to a C corporation, despite the mixed signals caused by the 1992 proposed regulations [*Sidell* (affirmed in the 1st Circuit); *Connor* and *Krukowski* (both affirmed in the 7th Circuit); *Schwalbach*]. For example, in *Sidell*, the Tax Court applied the final regulations to the *Sidell*'s 1993 tax year even though no clear regulatory guidance existed during 1992 and 1993. It is now clear that any self rental to an entity (C corp, S corp, LLC, or partnership) in which the taxpayer is a material participant will be recharacterized as nonpassive income.

705.17 **Rental of Nondepreciable Property.** Net income from a rental activity is recharacterized as nonpassive if less than 30% of the unadjusted basis of the rented property is subject to depreciation [Temp. Reg. 1.469-2T(f)(3)]. For example, income from leasing undeveloped land represents nonpassive income. These rules converting what appears to be passive income into nonpassive income apply only if net income occurs. If the activity produces a loss, it retains its passive character.

705.18 For this regulation, *unadjusted basis* means the adjusted basis of the property determined without regard to any adjustment described in IRC Sec. 1016 that decreases basis. Accordingly, when the "less than 30%" test is applied, the basis of any depreciable portion of the property is not reduced by previous depreciation of the asset.

Example 7-21: Rents from parking lot recharacterized as nonpassive (portfolio) income.

Harry Henderson receives rent income from a downtown parking lot he owns and leases to a company for use by its employees. His total unadjusted basis in the property is \$800,000, allocated \$600,000 to the land and \$200,000 to paving and other depreciable improvements. In 2006, he receives net rental income of \$80,000.

Because the unadjusted basis in the depreciable improvements (\$200,000) is less than 30% of the unadjusted basis of all the property (\$240,000), the \$80,000 of net rental income is recharacterized from passive to nonpassive income.

If Harry incurs \$60,000 or more of additional depreciable improvements to the property, the unadjusted basis in the depreciable improvements would increase from 25% to 30.2% of the total unadjusted basis. At that point, the rental income would no longer be subject to recharacterization.

705.19 If real property is subject to recharacterization in the year it is sold, gain from the disposal is also subject to recharacterization.

705.20 **Note:** For the recharacterization rule to apply, the activity must be treated as a rental activity under the Section 469 rules [Temp. Reg. 1.469-2T(f)(3)]. If one of the rental exceptions applies (see paragraph 705.3), the activity is not subject to this recharacterization rule; instead, the passive or nonpassive nature of the activity depends on the taxpayer's participation.

705.21 **Developer Sales of Rental Property.** In general, a rental activity is a passive activity, and gain from the disposition of property used in a passive activity during the year of disposition is treated as passive activity gross income [Temp. Reg. 1.469-2T(c)(2)(i)(A)]. However, a taxpayer who materially or significantly participates in the development of the property may have to recognize the rental income and the gain on the sale as nonpassive, even though it is rented during the year of sale [Reg. 1.469-2(f)(5)].

705.21

Avoiding Probate with a Beneficiary Deed

Our lawmakers are giving taxpayers another break from expending considerable amounts of cash paying for probates, family trusts, life estates or any other form documents which will transfer assets to their children in a future time, effective on the death of the last surviving owner.

On August 9, 2001 the legislature of the state of Arizona enacted an amendment to Title 33, Chapter 4, Article 1 of the revised statutes, by adding Section 33-405 and amending sections 11-1134 and 42-15101, relating to conveyances and deeds.

The law alleviates certain ambiguities regarding life estates and the rights or interest of the holder of the life estate and the owner of the remainder, when it comes to qualifying for a tax exemption offered to widows, veterans and senior citizens.

A beneficiary deed is made specific by conveying title effective on the death of the owner, or last surviving owner, thus creating an estate in expectancy which some time in the past was outlawed.

The grantee may be a multiple grantee or a successor grantee or both. A multiple grantee could acquire title as joint tenants with right of survivorship, as tenants in common or any other tenancy that is otherwise valid under the laws of the state of Arizona. A grant to a successor grantee shall state the condition on which the interest of the successor grantee would vest.

A beneficiary deed carries no warranties. It conveys an interest in real property including any debt secured by a lien on the property. It can also be revoked at any time by the owner, or in the event there are several owners, by any of the owners or by the last surviving owner. If the last surviving owner did not execute the beneficiary deed, the deed is invalid. Also in order to be valid it must be recorded as provided by law in the office of the Recorder of the county in which the property is located, before the death of the owner or the last surviving owner.

Because of the uniqueness of this type of conveyance it may not be necessary to insure a transfer made by a beneficiary deed, since actual title may be had in a future time, that is if it has not been revoked or transferred to another individual or entity.

In any event it seems that this type of transfer is ideal for simple estates. It avoids probate and does away with potential adversities of a joint tenancy with right of survivorship estate, which so far has been for the average Arizonan the "panacea" for avoiding probate.

The Assessor's title transfer department has developed guidelines for this type of transfer. The public should be able to view in the internet the name of the owner followed by the initials BD (Beneficiary Deed) and the beneficiary's name will be disclosed immediately after the legal description.

<http://www.co.yavapai.az.us/Content.aspx?id=19530>

Arizona Beneficiary Deeds

by Richard Keyt, Arizona real estate attorney

Table of Contents

1. Benefits of an Arizona Beneficiary Deed
2. Draw Backs to Using an Arizona Beneficiary Deed
3. Owner May Name Multiple & Successor Grantees
4. Examples: 1, 2, 3, 4 & 5
5. Form of Arizona Beneficiary Deed Approved by Statute
6. Form of Revocation of Arizona Beneficiary Deed Approved by Statute
7. KEYTLaw Arizona Beneficiary Deed Preparation Service
8. Mail or Email this Article to a Family Member or Friend
9. Beneficiary Deed Questionnaire - complete this form online to order your deed for \$150

On April 11, 2001, the Governor of Arizona signed into law Arizona Revised Statutes Section 33-405, which created a new type of Arizona real property deed known as the Arizona beneficiary deed. By signing and recording an Arizona Beneficiary Deed, an owner of an interest in real property located in Arizona may cause the owner's interest in the real property to be conveyed to people or entities on the owner's death. The interest in real property conveyed by a Beneficiary Deed does not take effect until the death of the owner, at which time that interest transfers automatically by law to the designated grantee(s) named in the Beneficiary Deed.

Benefits of an Arizona Beneficiary Deed

The benefits of an Arizona Beneficiary Deed are:

1. Arizona real property transferred by an Arizona Beneficiary Deed avoids the cost and delay of probate because the property is not part of the probate estate of the deceased owner. Avoiding probate can save a family \$1,500 to \$3,000 or more in legal fees.
2. Transferring property by an Arizona Beneficiary Deed is a much cheaper method of avoiding probate than a living trust. The most common method to avoid probate is to create a trust and convey the real property to a trustee. Estate planning lawyers typically charge \$1,500 - \$2,500 or more to create a living trust.
3. An Arizona Beneficiary Deed is much simpler than creating and administering a trust. Property must be conveyed by deed to the trustee and the trustee must administer the property according to the terms and conditions of the trust agreement. With an Arizona Beneficiary Deed, the owner retains total control over the property.
4. After an Arizona Beneficiary Deed is signed and recorded, the owners may sell, encumber or otherwise deal with their property without any restrictions or limitations.
5. Signing and recording an Arizona Beneficiary Deed has no gift tax liability because it is not a present transfer of property.
6. The owner is free to change an Arizona Beneficiary Deed at any time.
7. The owner may revoke an Arizona Beneficiary Deed at any time by recording an appropriate revocation with the county recorder of the county in which the property is located.

Draw Backs to Using an Arizona Beneficiary Deed

Some of the negatives associated with an Arizona Beneficiary Deed are:

1. Because the property is not transferred until the death of the last owner, the full value of

the property remains in the estate of the deceased for estate tax purposes.

2. If any beneficiary is a minor child, the child's interest will be left outright to the child unless the deed provides that the interest is left to the child in a trust or to an adult for the child under the Arizona Uniform Gift to Minors Act.

3. In general, when there are multiple beneficiaries, they will own undivided interests in the property, which can make managing and dealing with the property more difficult and cumbersome than if it were held in a trust or by an entity like a limited liability company or a family limited partnership.

4. If property is owned as joint tenants with right of survivorship, the last survivor may revoke or modify the deed and frustrate the intent of the prior decedent(s). One way to avoid this problem is by using a trust that becomes irrevocable after the first death.

The above list is not all inclusive. We recommend that you consult with an experienced estate planning lawyer to discuss the pros and cons of using an Arizona Beneficiary Deed versus a comprehensive estate plan that includes a will and living trust. It may be that for you, a trust might be a better vehicle to accomplish your estate planning objectives.

Owner May Name Multiple & Successor Grantees

The owner of real property may name multiple grantees or a successor grantee(s), or both. Multiple grantees may take their interests as joint tenants with right of survivorship, tenants in common, community property, community property with right of survivorship, or any other tenancy that is otherwise valid under Arizona law. A grant to a successor grantee shall state the condition on which the interest of the successor grantee would vest.

Arizona Beneficiary Deed Example 1

If real property is owned as joint tenants with the right of survivorship or as community property with the right of survivorship, a deed that conveys an interest in the real property to a grantee designated by all the then surviving owners and that expressly states that the deed is not to take effect until the death of the last surviving owner transfers the interest to the designated grantee beneficiary effective on the death of the last surviving owner.

Example 1: John & Mary are married and own their home as community property with right of survivorship. They sign and record a Beneficiary Deed that names their children, Dick & Jane as their beneficiaries (grantees) as tenants in common only on the death of the last to survive of John & Mary. John dies two years later. At this time, Mary is the sole owner of the property. Mary dies ten years after John without selling or disposing of the property or revoking the Beneficiary Deed. Result: On the date of Mary's death, Dick & Jane become the owners of the property as tenants in common.

Arizona Beneficiary Deed Example 2

If real property is owned as joint tenants with right of survivorship or community property with right of survivorship and if the Beneficiary Deed is signed by less than all of the owners of the real property, the Beneficiary Deed will be valid if the last surviving owner is one of the persons who signed the Beneficiary Deed. If the last surviving owner did not sign the Beneficiary Deed, the deed is invalid.

Example 2: John & Bob are unmarried brothers and they acquire real property as joint tenants with right of survivorship. John signs, delivers and records a Beneficiary Deed that conveys his interest in the property to Jane on his death. Bob does not sign a Beneficiary Deed.

Result 1: If John dies before Bob, Bob acquires sole ownership of the property by

operation of law at the time of John's death. John's Beneficiary Deed is invalid.

Result 2: If Bob dies before John, John acquires sole ownership of the property by operation of law at the time of Bob's death. If John does not sell or dispose of the property or revoke the Beneficiary Deed, then on his death, Jane will acquire sole ownership of the property.

Arizona Beneficiary Deed Example 3

A Beneficiary Deed will be valid only if the Beneficiary Deed is signed and recorded as provided by Arizona law in the office of the county recorder of the county in which the real property is located. A Beneficiary Deed must also be properly recorded before the death of the owner or the last surviving owner.

Example 3: John & Mary are married and own their home as community property with right of survivorship. They sign and record a Beneficiary Deed that names their children, Dick & Jane as their beneficiaries (grantees) as tenants in common only on the death of the last to survive of John & Mary. Assume any of the following events were to occur: (i) the legal description on the Beneficiary Deed does not describe the property owned by John & Mary, (ii) the Beneficiary Deed was recorded in a county other than the county in which the property is located, or (iii) the Beneficiary Deed is signed and properly acknowledged before a notary public, but it is not recorded in the proper county until after John and Mary die. Result: The Beneficiary Deed is not valid and does not convey any interest in the home to Dick & Jane.

Arizona Beneficiary Deed Example 4

An owner who signs and records a Beneficiary Deed may revoke the Beneficiary Deed at any time. If there is more than one owner, a Beneficiary Deed may be revoked by any of the owners who signed the Beneficiary Deed. If a Beneficiary Deed conveys interests of more than one owner and the revocation of the Beneficiary Deed is not signed by all the owners, the revocation will not be effective unless the last surviving owner is the party that properly revoked the Beneficiary Deed. Note: If all the owners of real property want to revoke their Beneficiary Deed, they should all sign the revocation to make sure the revocation becomes valid. To be effective, the revocation must be signed and recorded as provided by law in the office of the county recorder of the county in which the real property is located before the death of the owner who signs the revocation.

Example 4: John & Mary are married and own their home as community property with right of survivorship. They sign and record a Beneficiary Deed that names their children, Dick & Jane as their beneficiaries (grantees) as tenants in common only on the death of the last to survive of John & Mary. John later revokes his Beneficiary Deed by signing, properly notarizing and properly recording a revocation in the proper county. Mary does not revoke her Beneficiary Deed.

Result 1: If John dies before Mary, Mary acquires sole ownership of the property by operation of law at the time of John's death. John's revocation of his Beneficiary Deed is not effective. If Mary does not sell or dispose of the property or revoke the Beneficiary Deed, then on her death, Dick & Jane will acquire ownership of the property as tenants in common.

Result 2: If Mary dies before John, John acquires sole ownership of the property by operation of law at the time of Mary's death. If John does not sell or dispose of the property, then on his death, the Beneficiary Deed would have been revoked and of no effect.

Arizona Beneficiary Deed Example 5

If an owner signs and records more than one Beneficiary Deed concerning the same real property, the last Beneficiary Deed recorded is the effective Beneficiary Deed.

Example 5: John is the sole owner of his home. He signs, properly acknowledges and records a Beneficiary Deed that conveys his interest in the home to his daughter Jane on his death. Two years later, John signs, properly acknowledges and records a Beneficiary Deed that conveys his interest in the home to his son Dick on his death. Result: By signing and properly recording the second Beneficiary Deed to Dick, the first Beneficiary Deed to Jane was revoked.

Form of Arizona Beneficiary Deed Approved by Statute

Arizona Revised Statutes Section 33-405.G provides that a Beneficiary Deed is sufficient if it complies with other applicable laws and if it is in substantially the following form:

Beneficiary Deed

I (we) hereby convey to _____ (Grantee) effective on my (our) death the following described real property:

(legal description)

(signature of Grantor(s))

(acknowledgment).

Form of Revocation of Arizona Beneficiary Deed Approved by Statute

Arizona Revised Statutes Section 33-405.H provides that the instrument revoking a Beneficiary Deed shall be sufficient if it complies with other applicable laws and is in substantially the following form:

Revocation of Beneficiary Deed

The undersigned hereby revokes the Beneficiary Deed recorded on _____ (date), in docket or book _____ at page _____, or instrument number _____, records of _____ County, Arizona.

Dated: _____

Signature

(acknowledgment).

Caution: To be recorded, all deeds and other documents must satisfy the conditions set forth in Arizona Revised Statutes Section 11-480.

The new Beneficiary Deed is an excellent way for owners of real property located in Arizona to convey interests in the property effective on death. This new type of Arizona deed can assist in estate planning and be used to avoid probate.

Property owners, however, should not prepare, sign and record Beneficiary Deeds without first obtaining counsel from an Arizona attorney who is familiar with Arizona real property conveyances and deeds and/or estate planning. Without proper legal advice or guidance, a property owner who prepares and records a deed without legal counsel takes a risk that the deed is defective or that it may not be sufficient to accomplish the property owner's objectives. Deeds are legal documents and they should always be reviewed by a competent attorney before being signed or recorded.

KEYTLaw Arizona Beneficiary Deed Preparation Service

KEYTLaw prepares Arizona Beneficiary Deeds and four other related documents for \$150. See the list of services provided for this fee, which includes five custom drafted documents: (1) the Arizona Beneficiary Deed, (2) a letter to your county recorder to record the Arizona Beneficiary Deed, (3) a Revocation Deed (for later use if you change your mind and want to revoke your previously recorded Arizona Beneficiary Deed), (4) a letter to the county recorder to record the Revocation Deed, and (5) a letter explaining the deed other documents. If you are interested in hiring KEYTLaw to prepare an Arizona Beneficiary Deed kit, click here to go to our Arizona Beneficiary Deed Questionnaire for more information.

About the Author

Richard Keyt is a business, real estate, transactions, contracts, estate planning and internet law attorney licensed to practice law in Arizona. He has provided legal services to businesses and people in Arizona since 1980. Rick does not accept matters involving landlord / tenant disputes or litigation of any kind (other than tax lien foreclosures). Rick can be reached by telephone at 602-906-4953, email at rickkeyt@keytlaw.com and fax at 602-906-1081. Communicating with Richard Keyt via email or otherwise does not cause you to become a client or cause your communications to be confidential or subject to the attorney client privilege.

<http://www.keytlaw.com/az/benedeeds.htm>

This article was first published on November 25, 2001

This page was last modified on February 06, 2006.