

Investment Property Exception to \$10,000 Cap on Itemized Deduction for State and Local Property Taxes?



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As it relates to individuals, one of the more controversial aspects of the 2017 revenue act (commonly referred to as the "Tax Cuts and Jobs Act") is the \$10,000 cap on itemized deductions for state and local taxes. Historically, the ability to deduct income taxes (or general sales taxes, if elected instead of income taxes) and property taxes paid to state and local taxing authorities has been a valuable tax break for individual taxpayers who itemize deductions on their federal income tax returns. But, as we know, itemized deductions for state and local taxes are limited to a combined total of \$10,000 (\$5,000 in the case of a married individual filing a separate return) for the 2018 through 2025 tax years. The itemized deduction for state and local taxes is reported on Line 5 of Schedule A to the IRS Form 1040, U.S. Individual Income Tax Return.

There is an interesting issue regarding whether real property taxes imposed on vacant land held by individual real estate investors who are not in the business of buying and selling property on a continuous basis are subject to the \$10,000 cap. Typically, the real estate investor has no income from vacant land, and since the real estate investor is not engaged in a business related to the real property holding, he or she is not entitled to business deductions and does not file Schedule C. Prior to the enactment of the Tax Cuts and Jobs Act, an individual real estate investor who purchased raw land as an investment, hoping that over time it would appreciate in value, would deduct the real estate taxes on such land as a personal itemized deduction on Schedule A.

At first blush, it may appear that § 164(b)(6)(B) traps the real estate taxes imposed on vacant land held for investment along with all other state and local taxes. However, § 164(b)(6)(B) goes on to state that the \$10,000 cap shall not apply to state and local real property taxes ***"which are paid or accrued in carrying on a trade or business or an activity described in section 212."*** Pursuant to § 212(1) and (2), individuals are entitled to deduct ordinary and necessary expenses paid "for the production or collection of income" and "for the management, conservation, or maintenance of property held for the production of income." Pursuant to Treasury Regulations § 1.212-1(b), "[t]he term "income" for the purpose of section 212 includes not merely income of the taxable year but also income which the taxpayer has realized in a prior taxable year or may realize in subsequent taxable years; and is not confined to recurring income but applies as well to gains from the disposition of property."^[1]

Many tax professionals have argued that the reference to § 212 limits the application of § 164(b)(6)(B), giving real estate investors the right to continue to take itemized deductions that exceed the \$10,000 cap for real property taxes associated with their vacant lot investment holdings. It has been suggested that such deductions should be reported as "Other Taxes" on Line 6 of Schedule A to the IRS Form 1040.

Other tax professionals have disagreed with this position, arguing that the temporary suspension of miscellaneous itemized deductions under § 67(g) prohibits a taxpayer from claiming a deduction for § 212 expenses. Section 67(g), however, bars “miscellaneous itemized deductions.” Pursuant to § 67(b)(2), the deduction for real property taxes under § 164(a) is specifically excluded from the definition of “miscellaneous itemized deduction.” As a result, proponents for continuing to deduct real property taxes for investment holdings in excess of the cap have argued that the taxes in this case are not subject to § 67(g) because they are being deducted under § 164 and not under § 212. In other words, because § 164 simply requires the taxpayer to reference § 212 to determine whether the activity giving rise to the tax (i.e., holding real property for investment) would be covered by that section, the actual deduction (under § 164) should be excluded from the bar on miscellaneous itemized deductions.

[\[1\]](#) “Expenses paid or incurred in managing, conserving, or maintaining property held for investment may be deductible under section 212 even though the property is not currently productive and there is no likelihood that the property will be sold at a profit or will otherwise be productive of income and even though the property is held merely to minimize a loss with respect thereto.” Treas. Regs. § 1.212-1(b).