

## Capitalizing Carrying Costs Under Sec. 266

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- A. Under Sec. 266, taxpayers can elect to capitalize tax and other costs of carrying unimproved, unproductive real property in lieu of claiming current deductions for these expenditures. When the Section 266 election is made, the otherwise potentially deductible carrying costs are added to the tax basis of the land. Therefore, making the election postpones any tax benefit from the otherwise-deductible carrying costs until the land is sold.
1. In the case of raw land held by an individual for investment purposes, Reg. 1.266-1(B)(1)(i) allows the taxpayer to capitalize the following three otherwise-deductible items: (1) annual property taxes, (2) mortgage interest (which would otherwise fall under the Sec. 163(d) investment interest limitation rules), and (3) other carrying charges such as the cost of moving and pesticide application (which would otherwise be treated as Section 212 production-of-income expenses that were formerly deductible under the 2%-of-AGI floor for miscellaneous itemized deductions.)
  2. Note: For real estate dealers, the Section 263A uniform capitalization rules may require that real property carrying charges be capitalized as inventory costs. Therefore, the Section 266 election may not be of any use to dealers.
- B. Starting in 2018 the state and local tax deduction (SALT) is limited to \$10,000 (\$5,000 for married filing separately), as opposed to prior tax years when there was no limitation.
1. This will result in taxpayers who simply deducted property taxes on unimproved, unproductive real property losing all or some of this deduction.
- C. Example: Assume married filing jointly taxpayers own a principal residence and an unimproved lot held for investment. They purchased the lot in January 2024 for \$100,000. In 2024, they elect to itemize deductions. State and local taxes withheld were \$8,000, real estate taxes on their principal residence were \$3,000, real estate taxes on the unimproved land were \$5,000, and personal property taxes on automobiles and watercraft were \$1,000. Total State and Local Taxes are therefore \$17,000.

While the total SALT deduction is limited to \$10,000 under the TCJA, the taxpayer can potentially make a Reg. §1.266-1(b)(1)(i) election to capitalize the \$5,000 property taxes on the investment property. This reduces the SALT deduction to \$12,000 (W-2 taxes, real estate taxes on residence and watercraft). While the itemized deduction available on the 2020 return is still limited to \$10,000, the taxpayer's basis in the unimproved land is now \$105,000 (\$100,000 beginning basis + \$5,000 capitalized cost).

- D. If the Code Sec. 266 election is made annually, this will likely increase the basis in the investment property and this would prove to be highly valuable in future years, especially if the property appreciates in value. The potential savings from making the Code Sec. 266 election capitalizing property taxes on investment property over many tax years should not be underestimated. For example, if \$100,000 is capitalized over the period of ownership, and the taxpayer is subject to a 20% long-term capital gains tax rate and the 3.8% Net Investment Income Tax (NIIT), then the federal tax savings will be \$23,800 when the property is sold. In areas of the country with higher property tax rates, the tax benefit from this election can be even greater.
- E. Here are some other key points about how the Section 266 election works:
1. With raw land held by a pass-through entity, such as a partnership or LLC, the entity should consider making the Section 266 election if it would benefit its partners.
  2. With raw land, the election can be made selectively on a year-by-year basis and on a property-by-property basis. So, making the election for the present year, will not affect the ability to make or not make the election in future years. Similarly, making the election for one parcel of raw land for the current year apparently will not affect the ability to make or not make the election for other parcels for the current year [Sec. Reg. 1.266-1(c)(1) and (2)(I)].
  3. The election can apparently be made selectively with respect to some or all of the three types of otherwise-deductible raw land carrying costs listed earlier, but an election to capitalize an item (e.g., property taxes) must include all such items for that particular project [Reg. 1.266-1(c)(1)].
  4. Example. Your individual client Marcela holds raw land Parcels A and B for investment. For the current year, she can apparently elect to capitalize all of the real property taxes for Parcel A while still currently deducting the mortgage interest for that parcel. For Parcel B, Marcela can apparently choose to not make any Section 266 election and thereby currently deduct the carrying charges for that parcel. Alternatively, she can apparently elect to capitalize all the mowing and pesticide expenses for Parcel B while currently electing the property taxes and mortgage interest for that parcel. Finally, any Section elections made for the current year will not affect the tax treatment of Marcela's raw land carrying charges in future years.
- F. There are at least four reasons to make this election:
1. Individual Taxpayer is Subject to the AMT
    - a. The most obvious reason is when an individual is firmly in the dreaded AMT mode for the year. In this scenario, any deduction for property taxes is

completely disallowed. The disallowance is not just a time difference. Any federal income tax benefit from the property taxes simply goes up in smoke. Permanently! On the other hand if the taxpayer elects under Sec. 266 to capitalize raw land property taxes, a federal income tax benefit will be realized when the land is eventually sold (because the land's basis is increased by the amount of capitalized taxes). Clearly, getting a deferred tax benefit is better than getting no benefit at all.

## 2. Taxpayer Has Expiring NOL

- a. The second obvious situation where making the Section 266 election can make sense is when a taxpayer (individual or otherwise) has an expiring net operating loss (NOL). In this scenario, making the election will increase taxable income for the year and thereby allow the taxpayer to use up at least some of the NOL before it expires.

- 1) This would apply where the taxpayer is taking the carrying costs as a business deduction.

## 3. Taxpayer is Not Itemizing

- a. The third situation would be were the taxpayer is taking the carrying costs as an investment expense in the itemized deduction section of Schedule A. The carrying costs would not be deductible while adding them to the basis of the property will reduce the capital gain or make the capital loss larger in the future.

## 4. Individual Itemized Taxes Exceed \$10,000

- 1) With the \$10,000 limit on deductible taxes any property taxes on unproductive, unimproved real estate may not be otherwise deductible.

## G. Future AGI Considerations

1. Other potential significant tax savings from multi-year Code Sec. 266 elections is the resulting decrease in Adjusted Gross Income (AGI) in the year of sale for this type of investment property. An increase in basis will reduce capital gains realized and recognized in the year of sale, which will in turn lower AGI in the year of sale. Many tax benefits are still tied to AGI, such as:
  - a. Code Sec. 86 Social Security taxation phases-in when married filing jointly's modified adjusted gross income (MAGI) exceeds \$32,000.
  - b. Code Sec. 469 "Passive activity losses and credits limited" allows MFJ taxpayers a \$25,000 ordinary loss for rental activity, but the loss is phased-out at a 50% rate once their MAGI exceeds \$100,000.

- c. Code Sec. 213 “Medical, dental, etc., expenses” a deduction is allowed once eligible medical expenses exceeds 7.5% of AGI.
- d. Code Sec. 221 “Interest on education loans” allows a \$2,500 deduction but is phased-out once MFJ taxpayers MAGI exceed \$100,000.

#### H. Making a Sec. 266 Election

1. To make the Code Sec. 266 election, taxpayers must prepare a statement including the taxpayer’s name, address, identifying number, an identification of the election and code section, the tax year, a list of what is being capitalized (and what is not), and how much is being capitalized [Reg. 301.910-T]. This statement should be attached to an original return.
  - a. There is no explicit requirement that the original return be filed on time. In Ltr. Rul. 8917026, the IRS said a valid election could be made on a late-filed original return. In any case, the statement must indicate the item or items and the property or project for which the capitalization election is made [Reg. 1.266-1(c)(3)].
2. An express election should be made to capitalize these expenses. They cannot simply be added to the basis if they were not deducted on a prior tax return. As the Tax Court opined in 1964, “The mere failure of petitioners to deduct an item ... separately on their return for [a prior tax year] was not an indication that they elected to capitalize the expense.” [J. Green, 3 TCM 649]
3. Relief is available for late-filed elections (such as an amended return). However, taxpayers can not simply make the election on an amended return if it was not part of the original return. Relief must be requested in a private letter ruling, and will only be potentially granted if the taxpayer acted reasonably, in good faith, and the “grant of relief will not prejudice the interests of the government.” [Reg. 301.9100-3(c)(1)] The interests of the government are considered prejudiced if relief is granted for a year closed by the statute of limitations [Reg. 301.9100-3(c)(1)(ii)]. Also, the interests of the government are considered prejudiced by granting relief if the taxpayer would have a lower tax liability in the aggregate for all taxable years, affected by the election [Reg. 301.9100-3(c)(1)(i)].
  - a. Note: In a series of private letter rulings, the IRS has granted taxpayers the right to make Section 266 elections after they filed returns without valid elections. (See, for example, Ltr. Ruls. 200629025 and 199932056). However, requesting a private letter ruling is after-the-fact damage control, and it requires paying a user fee. Better to simply get the election right the first time.

## I. Sample Section 266 Election Statement

Taxpayer Name  
Taxpayer Street Address  
Taxpayer City, State, Zip

Taxpayer Identification Number

For the Year Ending December 31, 20XX

Pursuant to Section 266 of the Internal Revenue Code, the taxpayer hereby elects to capitalize rather than currently deduct the following otherwise-deductible carrying charges for the following properties:

Raw Land Parcel A in Gadsden, Alabama

Property taxes	\$18,500
Mowing costs	1,200
Pesticide applications	<u>1,500</u>
Total for the property	\$21,200

Raw Land Parcel B in Meridian, Mississippi

Mortgage Interest	<u>\$33,000</u>
Total for this property	\$33,000