OTHER REAL ESTATE ISSUES

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I. PRINCIPAL RESIDENCE PROVISIONS

A. Exclusion Of Gain From Sale Of Principal Residence IRC §121

This exclusion rule provides that up to $250,000 of gain ($500,000 MFJ) realized on the sale or exchange of a principal residence is not taxable if certain prerequisites are satisfied. This permanent exclusion is allowed each time a homeowner meets the eligibility requirements, but generally no more frequently than once every two years.

The new §121 rules can be summarized as follows:

- Law allows $250,000 exclusion of gain on sale of personal residence.after 5/6/97.
- Law allows $500,000 gain exclusion if taxpayers file a married joint return in the year of sale and meet certain other requirements.
- Law requires seller to own and use the house of 2 of 5 years before the sale.
- Exclusion can be used once every 2 years.
- No deferral of gain is allowed.

1. How To Determine If A Home Is The Principal Residence

The regulations provide that the residence that the taxpayer uses a majority of the time during the year will ordinarily be considered the taxpayer's principal residence. However, the IRS will consider facts and circumstances. The final regulations also include a nonexclusive list of factors that are relevant in identifying a property as a taxpayer's principal residence. (§1.121-1(2) (i)-(vi)).

a. The taxpayer's place of employment;
b. The principal place of abode of the taxpayer's family members;
c. The address listed on the taxpayer's federal and state tax returns, driver's license, automobile registration, and voter registration card;
d. The taxpayer's mailing address for bills and correspondence;
e. The location of the taxpayer's banks; and
f. The location of religious organizations and recreational clubs with which the taxpayer is affiliated.

2. $250,000/$500,000 MFJ Exclusion

If the taxpayer meets the above qualifications, up to $250,000 of gain ($500,000 on a joint return) may be excluded from gross income (§121(b)(1) and (2)).

Example

Cindy sold her principal residence for $330,000 in October 2007. She had purchased the home twenty years earlier for $40,000 and had added improvements of $25,000 to it. She paid commissions and other closing costs of $30,000. Her total gain is excluded if she uses the $250,000 exclusion rule.

Gain or Loss Computation

Sales Price		$330,000
Less Selling Expenses		30,000
Equals Amount realized		330,000
Less: Adjusted basis		
Original cost (basis)	$40,000	
Plus: Improvements	$25,000	
Equals: Total adjusted basis:		- 65,000
Gain realized on sale		$235,000
Less: $250,000 Exclusion		**- 250,000**
TAXABLE GAIN ON SALE		= NONE

B. Homeowner Must Own And Use The Residence

During the five-year period ending on the date of the sale or exchange, the taxpayer must have owner and used the property as a principal residence for periods aggregating 2 years or more. Presumably this 2-year ownership and use requirement may be satisfied by establishing ownership and use for either 24 full months, or 730 days (365 x 2) during the 60 month time period prior to sale (§121(a); see Reg. §1.121-1(c)).

> **Comment:** The ownership and use requirement can be met with only 2 years of ownership. If a homeowner owns and uses the same home for 2 years, he or she has automatically met the 2-of-the-last-5 years requirement."

The Ownership and Use Tests Do Not Have to Be Met Simultaneously

However, satisfaction of both condition must occur within the 5-year period ending on the date of sale or exchange. In other words, a tenant who purchases the home can count the time as a tenant as part of the use requirement. Also, a homeowner can rent out his or her home and still count that time toward the ownership requirements (Rev. Rul. 80-172, 1980-2 CB 56).

Sales or Exchanges of Partial Interests (§1.121-4 Special Rule)

A taxpayer may apply §121 exclusion to gain from the sale or exchange of an interest in the taxpayer's principal residence that is less than the taxpayer's entire interest if the interest sold or exchanged includes an interest in the dwelling unit. However, sales or exchanges or partial interests in the same principal residence are treated as one sale or exchange. Therefore, only one maximum limitation amount of $250,000 ($500,000 for joint returns) applies to the combined sales or exchanges that occur in different taxable years. A taxpayer may exclude gain from the first sale or exchange of a partial interest up to the taxpayer's full maximum limitation amount and may exclude gain from the sale or exchange of any other partial interest in the same principal residence to the extent of any remaining maximum limitation amount.

> **Note:** For purposes of applying the 1 sale every 2 years rule of §121(b)(3), each sale or exchange of a partial interest is disregarded with respect to other sales or exchange of a partial interests in the same principal residence, but is taken in account as of the date of sale or exchange and sale or exchange of any other principal residence.

Occasional Absence Allowed

Short, temporary absences, such as vacations or other seasonal absences, even when accompanied by rental of the residence, are counted as periods of use (§1.121-1(c)(2)).

One Year Required for the Physically or Mentally Incapacitated

A taxpayer who becomes physically or mentally incapable of self-care and who has owned and used a property as a principal residence for at least 1 year during a 5-year period is treated as using the property as a residence during any time in which the taxpayer owns the property and resides in a state-licensed facility (including a nursing home) (§121(d)(7)).

Example

One January 1, 2007, Lynn purchased and moved into her new personal residence. On July 31, 2008, she moved in the Powder River County Memorial Nursing Home. As long as Lynn continues to own the residence while she is in the nursing home, she is treated as though she continues to live in her residence. If Lynn owns the residence for at least 2 years and lives in the residence for at least one year and lives in the residence and nursing home for a total of 2 years, she may use the $250,000 exclusion.

> **Note:** Because the move to a nursing home is presumably for medical reasons, even if the residence is not owned for 2 years, a prorated portion of the exclusion applies.

Sale of Personal Residence by Surviving Spouse

HR 3648 Mortgage Forgiveness Debt Relief Act of 2007

The 2007 Act now provides that in the case of a sale or exchange of property by an unmarried individual who spouse is deceased on the date of such sale the surviving spouse may exclude up the $500,000 from gain from the sale of the residence if it is within two years following the death of the spouse. The married couple had to be entitled to the $500,000 exclusion at the date of death.

> **Note:** For California taxpayers this provision would to help only spouses where the home was owned as the separate property of the surviving spouse and would not have received a step up in basis when the non-owner spouse died.

This provision is effective for sales after 12/31/07.

Compare Prior Law

If one spouse dies, and the home is sold in the year of the deceased spouse's death, the surviving spouse can file as married filing joint, with the $500,000 MFJ exclusion available. If the home is sold in a subsequent year, the spouse was required to file as single, with only the $250,000 exclusion available.

Divorced Taxpayers

Tacking of use in divorce allowed in one situation. It is fairly common for divorce courts to order the family home sold and the proceeds split between former spouses. But if it takes time to sell the home, the parent granted custody of the children may be given exclusive use of the house rent-free until sale. When this exclusive use period extends beyond a reasonable time-a year or two-the IRS had successfully made the argument that the non-custodial parent was not "using" that home as his or her "principal residence" at the time of sale, and taxed the non-custodial parent's gain (*D.D. Bowers*, Dec. 51, 460(M); *C.B. Perry*, CA-9, 96-2 USTC ¶ 50, 405).

Rule for divorced homeowner. An individual (out-spouse) shall be treated as using property as principal residence during any period of ownership while such individual's spouse or former spouse (in-spouse) is granted used of the property under a divorce or separation instrument (§121(d)(3)(B)).

Tacking of *ownership* in divorce. When property is transferred between spouses during marriage or incident to a divorce, no gain or loss is recognized (even if one of the spouses receive cash for their interest) (§1041). However, the period such individual owns such property includes the period that the transferor owned the property (§121(d)(33)(A)).

> **Note:** Except for the special circumstances described above in which the in-spouse's use attributes to the out-spouse, no tacking of use is permitted under the new exclusion rules.

Allocation Rules (§1.121-1(e)) Property Used in Part as a Principal Residence

§121 will not apply to the gain allocable to any portion (separate from the dwelling unit) of property sold or exchanged with respect to which a taxpayer does not satisfy the use requirement. Thus, if a portion of the property was used for residential purposes and portion of the property **(separate from the dwelling unit)** was used for non-residential purposes, only gain allocable to the residential portion is excludable under §121.

Method of allocation: For purposes of determining the amount of gain allocable to the residential and non-residential portions of the property, the taxpayer must allocate the basis and the amount realized between residential and the non-residential portions of the property using the same method of allocation that the taxpayer used to determine depreciation adjustments.

No allocation is required if both the residential and non-residential portions of the property are within the same dwelling unit. (However, §121 does not apply to the gain allocable to the residential portion of the property to the extent depreciation has been claimed after May 7, 1997).

> **Tax Planning:** Surprisingly under these rules, it will no longer be necessary to convert the office in home or other business use of home which is not a separate structure back to personal usage for two years before selling to avoid taxation on the percentage of the house used for business.

Example

Kate (a single taxpayer sells her home for a $109,000 gain. She owned a property that consists of a house, and stable, and 35 acres. The stable and 28 acres were used for business purposes more than 3 years out of the 5 preceding the sale. Only the gain associated with the personal residence may be excluded under §121. The gain associated with the stables and 28 acres is taxable.

	Total	**Residence**	**Stable/28 acres**
Sales Price	$300,000	$200,000	$100,000
Original Cost	200,000	133,334	66,666
Accumulated Depreciation	-9,000	-0-	-9,000
Adjusted Basis	191,000	66,667	57,666
Gain	$109,000	$ 66,667 (Excludable)	$ 42,334 (Taxable)

How to Avoid Paying Taxes on Property Separate From the Dwelling Unit

Can the separate structure used for business be converted back to personal use? Yes … but! The property can only be converted back to non-business if the personal use meets "2 of the last 5 years of use" rule at the time of sale. Then the entire gain (less certain depreciation recapture) is eligible for the $250,000/$500,000 exclusion (Rev. Rul. 82-26, 1982-1 CB 114).

> **Planning:** As long as the personal use meets the "2 of the last 5 years of use" rule, it does not matter when the business use occurs. In other words, even if the taxpayer used the separate structure for business throughout the three years prior to sale, gain from the sale of the entire home (less certain depreciation recapture) may still qualify for the exclusion.

Depreciation Taken After May 6, 1997, must be Recaptured

Any gain attributable to the depreciation taken after May 6, 1997 with respect to the prior rental or business use of the principal residence must be recognized in the year of the sale (§121(d)(6)).

Rental of Personal Residence During Five Year Period

As long as the home is owned and used as a principal residence two out of the five years prior to sale date, it retains its personal residence character and does <u>not</u> switch to a taxable rental property (§121(a)).

The problem with renting a personal residence. When a personal residence is listed for sale in a "down" or "slow" market, it is common to rent the house until it is sold. Under prior law, care was needed to insure that the property retained its personal residence character and didn't convert to a rental (which wasn't eligible to use either the prior rollover provision or the period exclusion rule). Section 121 now provides a definitive period of time, 3 out of 5 years that the home can be rented before it converts into a rental ineligible to use the $250,000/$500,000 MFJ exclusion rule.

> **Planning:** This "tax loophole" allows homeowners to rent the house for up to 3 years while striving to sell it. There is no need to keep the property listed during the rental period. (*Clapham v. Comm.*, 63TC 505 (1975)).

No residence exists if the home is converted into rental. A homeowner who converts a principal residence into a rental may be faced with a realized and taxable gain a future sale. Once the personal residence has been rented for more that 3 of the last 5 years, the $250,000/$500,00 MFJ exclusion rule is <u>not</u> usable since the property is no longer deemed a personal residence. The taxpayer would be required to reoccupy the property as a principal residence for 2 of the last 5 years before the sale to reestablish the principal status.

II. REVENUE PROCEDURE 2005-14 – IRS WILL ALLOW THE §121 PERSONAL RESIDENCE EXCLUSION AND A LIKE KIND EXCHANGE UNDER §1031 ON THE SAME PROPERTY.

This Revenue Procedure applies to taxpayers who exchange property that satisfies the requirements of both §121 and §1031.

1. Taxpayer has lived in the house exchanged property that satisfies the requirements of both §121 for exclusion of gain and at the time of the exchange the property constitutes trade or business property for the purposes of §1031.
2. A taxpayer who exchanges a personal residence with a separate structure on the property used for business purposes.
3. A taxpayer who exchanges a dwelling unit partially used for business purposes (not a separate structure) for a new property with a separate structure used for business.

Computation

1. §121 is applied before §1031.
2. Gain attributable to depreciation will now be covered by §1031.
3. Any boot received is taken into account only if it exceeds gain excluded under §121.
4. In determining that basis of the property received in the exchange to be used in the taxpayer's trade or business or held for investment (the replacement business property) any gain excluded under §121 is treated as gain recognized by the taxpayer.

Example #1

Marian buys a house for $210,000 that she uses as her principal residence from 2002 to 2006. From 2006 to 2008 she rents the house to tenants and claims depreciation deductions of $20,000. In 2008, she exchanges the house for $10,000 cash and a townhouse with a FMV of $460,000 that she intents to rent to tenants. There is a gain of $280,000 on the exchange.

Results under Revenue Procedure 2005-14:

1. First, apply §121 as Marian to exclude gain qualifies under §121:

Sales Price	$470,000
Less Basis ($210,000-20,000)	(190,000)
	$280,000
Less Exclusion	($250,000)
Gain to be Deferred Under §1031	$ 30,000

2. The property also qualifies as business and investment property. Therefore the remaining gain may be deferred under §1031. Although boot was received of $10,000 it is not recognized as it does not exceed the amount of the excluded gain.

Basis of New Property	$460,000
Less Gain Deferred	(30,000)
Basis	$430,000

Example #2

Jack buys a property for $210,000. The property consists of two separate dwelling units, a house and a guest house. From 2003-2008, Jack uses the house as his principal residence and uses the guesthouse as an office in his business as a CPA. Based on the square footage of the receptive parts of the property Jack allocates 2/3 of the basis of the property to the house and 1/3 to the guest house. In 2008, Jack exchanges the entire property for a residence and separate property he intends to use as n office. The total FMV of the replacement properties is $360,000 ($240,000 for principal residence and $120,000 for business property).

Results under Revenue Procedure 2005-14:

	Total Property	**2/3 Residence**	**1/3 Business**
Amount Realized	**$360,000**	**$240,000**	**$120,000**
Basis	**$210,000**	**$140,000**	**$ 70,000**
Depreciation Adjustment	**$ 30,000**	**-0-**	**$ 30,000**
Adjusted Basis	**$180,000**	**$140,000**	**$ 40,000**
Realized Gain	**$180,000**	**$100,000**	**$ 80,000**
Gain Excluded Under §121		**$100,000**	
Gain Deferred under 1031			**$ 80,000**

Jack's basis in the new principal residence is $240,000. His basis in the business property is his old adjusted basis in the separate structure of $40,000.

Example #3

Using the same facts as in Example #2, if there is no separate structure business property and instead there is a 1/3 business usage of a dwelling unit (in the same structure) the following results occur:

	Total Property	**2/3 Residence**	**1/3 Business**
Amount Realized	**$360,000**	**$240,000**	**$120,000**
Basis	**$210,000**	**$140,000**	**$ 70,000**
Depreciation Adjustment	**$ 30,000**		**$ 30,000**
Adjustmed Basis	**$180,000**	**$140,000**	**$ 40,000**
Realized Gain	**$180,000**	**$100,000**	**$ 80,000**
Gain Excluded Under §121	**$150,000**	**$100,000**	**$ 50,000**
Gain Deferred under 1031	**$ 30,000**		**$ 30,000**

Jack's basis in the replacement residential property is the fair market value of the replacement residential property at the time of exchange ($240,000). Jack's basis in the replacement business property is $90,000, which is equal to C's basis in the relinquished business property at the time of the exchange ($40,000) increased by the gain excluded under §121 attributable to the relinquished business property ($50,000).

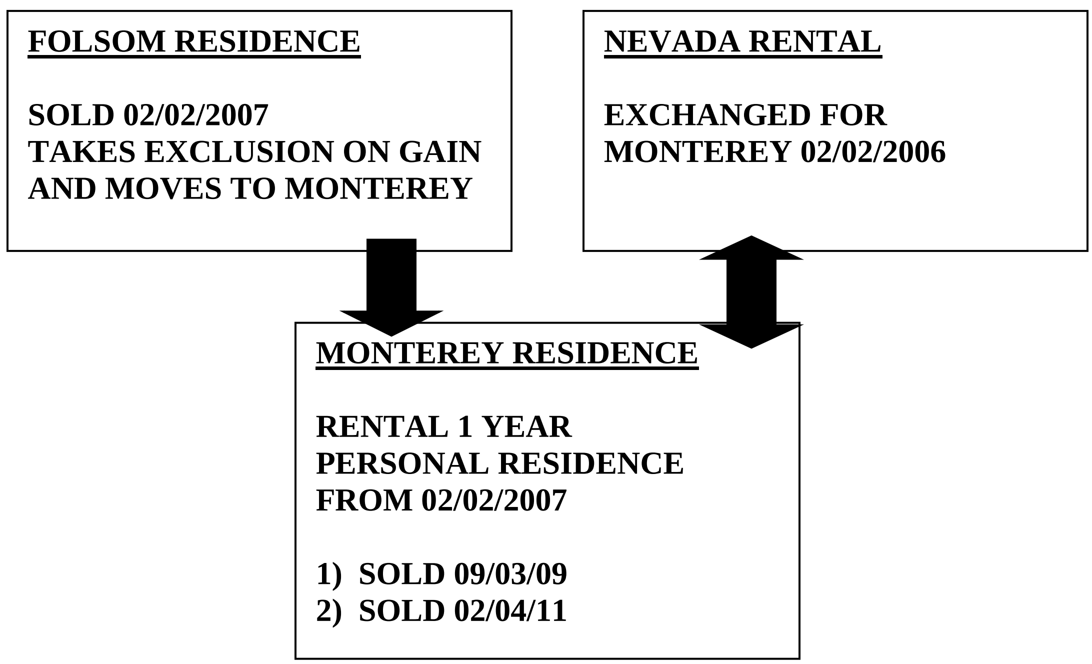
> **Note:** No allocation is required when the business property is part of a dwelling unit. Therefore, §121 exclusion is available for all of the gain except for depreciation claimed on the business property.

Comment: The wording of the Revenue Procedure suggests that the replacement business property must be s separate property and cannot be another room in the next personal residence.

III. HOMES ACQUIRED IN LIKE-KIND EXCHANGES – AMERICAN JOBS CREATION ACT OF 2004

The American Jobs Creation Act extended the period of ownership for homes acquired in a like-kind exchange to qualify for the §121 exclusion. The law now requires that the individual own the property for at least 5 years prior to its sale or exchange in order for the exclusion of gain rule to apply.

Example



Natalie Cash is a single individual. After she exchanges her rental for the house in Monterey and rents it for one year, she decides to make it her personal residence. If she lives in it more that 2 years ordinarily she would meet the §121 requirements of owning and using the house more than 2 years and could sell it on 09/03/2009 and take the exclusion. However, under the 2004 provision in the American Jobs Creation Act she must own the house for at least 5 years before she is eligible to exclude gain.. She will have to wait until 02/04/2011 to qualify.

Comment: The law does not preclude the exclusion, it only delays the use of it.

A. The $250,000 Doubles To $500,000 If Four Requirements Are Met

1. Husband and wife make a joint return for the taxable year of the sale of exchange of the property,
2. Either spouse owns the property for 2 of the last 5 years,
3. Both spouses use the property as their principal residence for 2 two of the last 5 years, and
4. Neither spouse is ineligible because more than one sale or exchange has been used during the previous 2 years (§121(b)(2)).

   Comment: The 2-year requirement does not prevent a husband and wife filing jointly from each excluding up to $250,000 of gain from sale of each spouse's principal residence provided that each spouse would be permitted to exclude up to $250,000 of gain if they filed separate returns.

   Comment: This seems to allow a couple to have 2 principal residences if they are not living together, but are filing jointly.

Rules Apply As Though Each Spouse Single

If a husband and wife make a joint return for the taxable year of the sale or exchange of the principal residence, the $250,000 exclusion rule and the proration of gain rule apply if either spouse meets the ownership and use requirements (§121 (d)(1)) (see examples below). In other words, the $250,000 exclusion applies separately to each spouse or the $500,000 exclusion applies to the couple. Therefore, if a single taxpayer who is otherwise eligible for an exclusion marries someone who has used the exclusion within the 2 years prior to the marriage, the newly married taxpayer is allowed a maximum exclusion within $250,000, even if a joint return is filed.

Once both spouses satisfy the eligibility rules and two years have passed since the last exclusion was allowed to either of them, the taxpayers may exclude $500,000 MFJ of gain on their joint return. The determination of whether and individual is married will be determined by the election to make joint return, not as of the date of the sale or exchange (§1.6013-1(a)).

> **Desperate Idea:** Single taxpayers with profits in excess of $250,000 may want to marry their over-two-year-live-in to gain an additional $250,000 tax shelter!

Owning a Home with a "Significant Other"

If two unmarried individuals jointly own and use one principal residence, the $250,000 exclusions provisions will apply independently to each upon a sale of the residence. The home is treated like a duplex owned by a joint venture partnership. (Regulations §1.121-2(a)(2).

§121 is Optional

This exclusion rule is NOT mandatory, and the taxpayer(s) may elect out of this rule and have the gain taxable (§121(f)). This provision is denied to disqualified expatriates (§121(e); §877(a)(1)).

When would a taxpayer elect to have a gain taxable when it could be tax-free?

Example
Jane marries Alfred on January 1, 2007. On May 15, 2007, they sell Alfred's old home for a $10,000 gain. On January 15, 2008, they sell Jane's home for a $500,000 MFJ gain. It would be smarter for Alfred to elect to make his $10,000 gain taxable so that Jane and Alfred can file jointly and use their combined $500,000 MFJ exclusion. (Assuming Alfred has lived in it for 2 years). If he uses it against the $10,000, he cannot again use the exclusion until 2 years after May 15, 2010, and Jane could exclude only $250,000.

B. Exclusion Available Only Once Every Two Years

With some notable exceptions, the $250,000/$500,000 MFJ exclusion rule does not apply if during the 2-year period ending on the date of sale or exchange there are any other sales or exchanges by the taxpayer in which the exclusion was previously used (§121(b)(3)(a)).

What Happens If the Homeowner Can't Meet the 2-Year Rule?

Final Regulations – Reduced Exclusions (§1.121-3T(h))

Final Regulations issued in 2004 outline safe harbors and other rules for determining when a reduced maximum exclusion may be available for a taxpayer who sells or exchanges property used as the principal residence but fails to satisfy the ownership and use requirements that have been discussed above.

Three exceptions permit the homeowner to still exclude some of the gain: A portion of the $250,000/$500,000 exclusion is still available even if the taxpayer (a) cannot meet the 2-of-the-last-5-year-rule ownership test, (b) cannot meet the 2-of-the-last-5-year-rule use test, or (c) has used this exclusion rule within the last 2 years, if the reason the homeowner cannot comply with the two year rule is because of:

1. Change of place of employment,
2. Health, or
3. Other unseen circumstances, to the extent provided in future IRS regulations (§21(c)(2)).

The final regulations make clear that taxpayers automatically qualify for a reduced gain exclusion when one of the following regulatory safe-harbors applies.

1 Change of Employment: Safe Harbor: If a new place of employment of a "qualified individual" is at least 50 miles farther from the residence sold or exchanged that was the former place of employment then primary reason for the move is "deemed" to be because of a change in employment.

Note: if the individual was unemployed, the distance between the new place of employment and the residence sold or exchanged must be at least 50 miles. (§1.121-3T(c)(2)(ii).

2 Health Reasons: A sale or exchange is for reasons of health if the taxpayer's primary reason for the sale or exchange is:

a. To obtain, provide or facilitate the diagnosis, cure, mitigation or treatment of disease, illness or injury or a qualified individual;

b. To obtain, provide medical or personal care for a qualified individual suffering from a disease, illness, or injury. (§1.121-3T(d)).

c. **Safe Harbor:** If the reason for a sale or exchange is because a physician recommends a change of residence for reasons of health then the sale or exchange is "deemed" to be for health reasons.

Definition of "Qualified Individual" includes the taxpayer, the taxpayer's spouse, a co-owner if the residence, a person whose principal place of abode is in the same household as the taxpayer and certain family members of these individuals (§1.121-3T(b)(5).

3. Unforeseen Circumstances: Definition: The primary reason for sale or exchange is the occurrence of an event that the taxpayer does not anticipate before purchasing and occupying the residence. (§1.121-3T(e)(1)).

Safe Harbor Events:

a. Involuntary conversion of the residence;
b. A natural or man-made disaster or act of war or terrorism resulting in a casualty to the residence;
c. In the case of a "qualified individual" (above)
   (1) death;
   (2) the cessation of employment as a result of which the individual in eligible for unemployment compensation
   (3) a change in employment or self-employment status that results in the taxpayer's inability to pay housing costs and reasonable basic living expenses for the taxpayer's household;
   (4) a divorce or legal separation under a decree of divorce or separate maintenance;

(5) multiple births resulting from the same pregnancy.

Note: The commissioner may designate other events or situations as unforeseen circumstances in published guidance of general applicability or in a ruling directed to a specific taxpayer. (§1.121-3T(e)(2)).

When a safe harbor does not apply then all relevant facts must be considered. Factors that may not be relevant in determining the taxpayer's primary reason for the sale or exchange include (but are not limited to) the extent to which:

1. The sale or exchange and circumstances giving rise to the sale or exchange are proximate in time;
2. The suitability of the property a the taxpayer's principal residence materially changes;
3. The taxpayer's financial ability to maintain the property is materially impaired;
4. The taxpayers uses the property as the taxpayer's residence during the period of the taxpayer's ownership of the property;
5. The circumstances giving rise to the sale or exchange are not reasonably foreseeable when the taxpayer begins using the property as the taxpayer's principal residence; and
6. The circumstances giving rise to the sale or exchange occur during the period of the taxpayer's ownership and use of the property as the taxpayer's principal residence.

Recent Letter Rulings (PLRs 200601023; 200601022; and 200601009)

In recent rulings taxpayers were successful in gaining IRS approval of a partial exclusion due to unforeseen circumstances.

One taxpayer moved to an over age 55 community only to have their daughter and grandchild move in with them due to the daughter's divorce. They had to move. IRS allowed the partial exclusion due to these particular unforeseen circumstances.

A second couple moved to another state and bought a house. Shortly after settling in they became aware of various criminal activities in their neighborhood and their son was assaulted. IRS determined that these were unforeseen circumstances and again allowed the pro-rata exclusion.

Excludable Gain

The excludable gain will be the fraction of the gain, the numerator being the shorter period of (1) the ownership and use period, or (2) the period between the 2 sales dates, and the denominator being 2 years.

Example

Bob, a single taxpayer working CID, purchased his Chicago home on July 1, 2000 and, after being transferred to Palo Alto, sold it on August 1, 2006 for a $70,000 gain (nontaxable under §121). He buys a Palo Alto home on July 1, 2006, but after only 6 months, he is transferred to Miami and sells his Palo Alto home on January 1, 2007 for a $60,000 gain. As he has not owned and used his Palo Alto home for a least 2 years, his excludable gain is limited by the shorter period calculated by the following formulas:

Alternative 1 – The "own and use days" rule

Date of current sale:	January 1, 2008
Date 5 years prior to current sale	January 1, 2003
Days Palo Alto home owned and used during this period:	183 days
July 1, 2007 through December 31, 2007	
183 own and use days/730 days (2 years) * $250,000 =	$62,671

Alternative 2 – The "days between sales" rule

Date of current sale:	January 1, 2008
Date of previous sale:	August 1, 2007
Total days in period:	152 days
152 days between sales/730 days (2 years) * $250,000 =	$52,055

Bob may exclude $52,055 (the <u>lesser</u> amount) of the $60,000 gain

Note: The partial exclusion is a fraction applies to the maximum exclusion and the gain.

What is One Spouse Qualifies and the other Doesn't?

On joint returns, the amount of the exclusion is the sum of the amounts to which each spouse is entitled if they were not married. Furthermore, each spouse is treated as owning the property during the period that either spouse owned the property (§121(b)(2)(B)).

Result: The exclusion may be something between $250,000 and $500,000.

Example

On January 1, 2006, Roberta and Dennis marry and Roberta moves into Dennis' home in San Jose which he has owned and lived in for the past five years. On January 1, 2007, Dennis and Roberta sell the San Jose home for a $500,000 profit and move to Texas so that Roberta can take a new job.

On their joint federal income tax return for 2007, Roberta and Dennis may claim and exclusion of $375,000 as follows:

Dennis	$250,000
Roberta (one year/two years * $250,000)	125,000
Total exclusion on joint return	$375,000

Roberta is able to use a portion of the exclusion because she is moving for a "good" (specified in the code) reason. If the couple were moving because Dennis was changing jobs, presumably, Roberta would get no exclusion.

How much gain is attributable to each spouse?

The code specifically states,

> "… each spouse shall be treated as owning the property during the period that either spouse owned the property."

This means that even if one spouse has no ownership interest at all, he or she may exclude some of the gain. Thus, some of the gain must be attributable to the non-owner souse. It would seem that the above rules contemplate that the gain from the sale of a home reported on a joint return can be allocated among the spouses in any matter. The Code is not clear on how to allocate gain or if an allocation is even necessary. The example below illustrates the possible events.

Example

Assume that Roberta and Dennis in the above example realize only a $300,000 gain on the sale of the San Jose home. Roberta and Dennis may exclude either $225,000 or the entire $300,000 depending on how the gain is allocated between them.

Gain Split	**50/50**	**Any Manner**
Dennis' Exclusion	$150,000 (50% of $300,000)	$250,000 (maximum exclusion)
Roberta's Exclusion	$ 75,000 (1 year/2 years x $150,000)	$ 50,000 (remaining gain)
Total Exclusion	**$225,000**	**$300,000**

IV. OTHER POINTS IN HOUSE SALES

Wealthy Homeowners May Be Forced to Report Gain

The amount in excess of the $250,000/$500,000 MFJ exclusion must be included in income even if all of the sales proceeds are reinvested in a new residence.

> **Comment:** For those homeowners selling principal residences with gains in excess of $250,000/$500,000 MFJ who reinvested, the repealed §1034 "rollover" provision was more beneficial.

> **Planning:** Planning for taxpayers with gain in excess of the excludible amounts might include converting the home to a rental (and later exchanging for multiple properties with lower gains in each) or increasing the number of owners.

Taxpayers Who Previously Used their "Once-in-a-Lifetime" Exclusion

Taxpayers who previously used their age 55, $125,000 exclusion are still eligible to use the new $250,000/$500,000 MFJ exclusion. "Pre-May1, 1997, sales are not taken into account," and, therefore, the once-every-two-year rule is "applied without regard to any sale or exchange before May 7, 1997" (§121(b)(3)(B)).

A Divorce Settlement May Move the Entire Gain to One Spouse

Transfer of property in divorce is a tax-free gift. As previously mentioned, there is generally no gain or loss recognized for transfers of property between spouses. Further, there is no recognition of gain or loss on the transfer of property to a former spouse if the transfer in incident to a divorce (§1041).

Example

Georgie Ann and Bob own a $490,000 home purchased 20 years before for $60,000 and a $490,000 condo in Aspen with a basis of $490,000. Neither property is encumbered with debt. They decide to get divorced. The divorce court awards the house to Georgie Ann and the condo to Bob. The following tax shifting occurs:

	Total	**Georgie Ann**	**Bob**
Fair market value	$980,000	$490,000	$490,000
Adjusted basis	<550,000>	<60,000>	<490,000>
Total gain	$430,000	$430,000	$ 0

This results in Bob's half of the inherent long-term capital gain being transferred to Georgie Ann. If both parties sell their divided properties the year after the divorce, Bob will pocket $490,000 tax-free and Georgie Ann will find $180,000 ($430,000 - $250,000 exclusion) of long-term capital gain on her single tax return!

Involuntary Conversions of the Principal Residence

The destruction, theft, seizure, requisition, or condemnation of the principal residence is treated as a sale (§121(d)(5)(A). Thus, any gain from the involuntary conversion of a principal residence (that otherwise qualifies) may be excluded up to the $250,000/$500,000 MFJ amount. §1033 applies to any excess gain. For purposes of §1033, the amount realized is reduced by the amount of the §121 exclusion (§121(d)(5)(B).

When Gain from the Sale of Vacant Land, Used as Part of the Residence, may Be Excluded

The sale or exchange of vacant land is not a sale or exchange of the taxpayer's principal residence unless:

a. The vacant land is adjacent to land containing the dwelling unit of the taxpayer's principal residence;

b. The taxpayer owned and used the vacant land as part of the taxpayer's principal residence;
c. The taxpayer sells or exchanges the dwelling unit in a sale or exchange that meets the requirements of §121 within 2 years before or after the date of the sale or exchange of the vacant land and
d. The requirements of §121 have otherwise been met with respect to the vacant land.

Example:

In 1992, Taxpayer Carol buys property consisting of a house and 10 acres that she uses as her principal residence. In May 2006, she sells 8 acres of the land and realizes a gain of $110,000. Carol does not sell the dwelling unit before the due date for filing her 2006 return, therefore she is not eligible to exclude the $110,000 of gain. In March 2008, Carol sells the house and remaining 2 acres realizing a gain of $180,000 from the sale of the house. She may exclude $180,000 of gain. Because the sale of the 8 acres occurred within 2 years from the date of the sale of the dwelling unit, the sale of the 8 acres is treated as a sale of the taxpayer's principal residence. Carol may file an amended return for 2006 to claim an exclusion for $70,000 ($250,000-$180,000) previously excluded) of the $110,000 gain from the sale of the 8 acres. (§1.121-1(2)(3)Ex.3.)

V. DISPOSITION OF A RENTAL

The gain or loss on the sale of a rental is calculated in the same manner as the gain or loss from the sale of other assets used in a trade or business. The gain or loss is the gross sales price less selling expenses less the taxpayer's basis. The basis is generally the cost plus improvements less accumulated depreciation. The gain or loss is reported on Form 4797. Gain from the sale of rental property is generally capital (except for the recapture of certain depreciation) gain while losses are ordinary.

Example

Dennis wants to know what the tax will be if he sells his duplex for $500,000. He estimates that selling expenses will be $35,000. Dennis bought the duplex ten years ago for $375,000. Since that time, he has made improvements costing $30,000 and has taken depreciation on the property and improvements of $105,000. Dennis' gain on sale is computed as follows:

Sales Price		$500,000
Less Selling Expense		- 35,000
Net Sales Proceeds		465,000
Less Basis		
Cost	$375,000	
Plus Improvements	30,000	
Less Depreciation	- 105,000	
Basis	$300,000	-300,000
Gain		$165,000
Federal Tax Is: 25%*$105,000	$ 26,250	
15%*$ 65,000	9,000	**$ 35,250**
State Tax (9% * $165,000)		14,850
TOTAL TAX		**$ 50,100**

Phase Outs Make Tax Even Higher

Because of phase outs, Dennis' federal tax in the year of sale is actually $50,850. Federal tax without the sale would have been $11,188. The **difference of $39,662** is the actual tax attributable to the sale rather than $35,250 above.

	Without Sale	**With Sale**
Ordinary Income	$100,000	$100,000
Capital Gain		**165,000**
Itemized Deductions	19,000	19,000
Less Phase-Out		1,051
Personal Exemptions	- 7,000	- 6,486
Taxable Income	$ 74,000	$240,565
Tax	**$ 11,188**	**$ 50,850**

Note: Federal tax number on the sale includes $4,021 of Alternative Minimum Tax.

> **Caution:** In this example, only itemized deduction and personal exemptions phase out due to the increase in income from capital gains. Taxpayers normally able to deduct losses from Active Participation Rental Real Estate may find that an increase to income

from capital gains prohibits the deduction of such losses, increasing current tax by much more than the 25% and 15% advertised rates on capital gains.

Alert: AMT may make tax even higher. In the above example, AMT is $3,365. Even though the new capital gain rates also apply 15% / 5% and 25% when calculating AMT, many high income taxpayers are finding themselves subject to AMT when they recognize a capital gain.

A. What Makes Most Economic Sense?

Back to Dennis, the tax is too high, but focusing on the tax obscures the bigger question. What course of action will have better economic results? Those results can be increased cash flow, more wealth in the future, or a combination of both. If there is no non tax reason for disposing of the property such as aversion to being a landlord, the starting place in the quest for best economic results is an analysis of continuing to own and rent the property versus selling and reinvesting the after tax proceeds. The following calculations illustrate such an analysis.

1. Keep As Rental – Sell In Five Years

		TAX	COST
Annual Rental Operation			
Rental Income		43,200	43,200
Interest/Payment		-24,000	-26,000
Insurance		-2,500	-2,500
Property Tax		-5,000	-5,000
Repairs		-5,000	-5,000
Management		-4,320	-4,320
Depreciation		-8,900	
Taxable Income			380
Tax Savings at 35%		-6,520	2,282
Annual After Tax Cash Flow			**2,662**
Sale in Five Years			
Sales Price (assume 3% appr.)		579,637	579,637
Selling Expense (assume 7%)		-40,575	-40,575
Basis:			
Cost	375,000		
Improvements	30,000		
Acc Depr	-155,000		
Basis	25,0000	-250,000	
Gain		289,062	
Gain Due to Depr (tax 25)		155,000	-38,750
Remaining Gain (tax 15%)		134,062	-20,109
State Tax (9%)			-26,016
Loan Payoff			-290,000
Cash From Sale in Five Years			**164,187**
Plus Annual After Tax Cash Flow of $2,662			
at 2% Before Tax and 35% Tax Rate			13,843
NET CASH IN FIVE YEARS			**178,030**

2. Sell And Invest Net Sales Proceeds

Cash From Sale	500,000
Selling Expenses	-35,000
Loan Payoff	-300,000
Federal Income Tax	-36,893
State Tax (9%)	-14,850
Cash From Sale	**113,257**
Invest for Five years at 2% less 35% Tax	
NET CASH IN FIVE YEARS	**120,919**

3. Alternatives To Selling The Rental Outright

Once a taxpayer has determined that the TAX IS TOO MUCH, it is time to examine alternative such as:

1. **Move into the property** – after the taxpayer has used the property as his or her principal residence for 2 years (and has owned it for 2 years) $250,000 ($500,000 on married filing joint return if both meet use test) of gain on sale may be excluded.

2. **Keep the property until death** – the taxpayer's beneficiaries will generally get a stepped up basis for the property to the fair market value at date of death and may sell the property without recognizing any gain. From an income tax standpoint, this may be the cheapest alternative but it does not help the taxpayer who wants his or her money out now nor does it help the taxpayer who is tired of being a landlord.

3. **Give the property to a Charitable Remainder Trust** – the trust sells the property without recognizing any gain and distributes income earned on the net sales proceeds to the taxpayer for his or her lifetime. The catch is that the taxpayer no longer owns the principal, only the income stream. This sophisticated strategy may be appropriate for the wealthy taxpayer and should be explored with the experts.

4. **Sell** the property using an installment sale – gain will be recognized over the period during which the sales proceeds are received.

5. **Exchange the property** – to the extent "like-kind" property is received, gain will be deferred. The last two alternatives, installment sale and exchange, are reviewed in more detail below.

B. Installment Notes

IN GENERAL

The installment sale provision provides the exception to the rule that the entire gain be reported the year a transaction is closed. The installment method permits the paying of the tax on a gain as payments on the sales price are received.

Installment sale treatment is automatic unless the taxpayer elects otherwise for taxpayers selling real property if at least one payment is received after the taxable year in which the sale occurs.

Electing Out

The election out of installment sale treatment may not be made on an amended return. The election is binding and is only revocable with the consent of the IRS. In Letter Ruling 9452034, the IRS spelled out when they would grant a revocation of an installment election:

1. The taxpayer intended to do so.

2. Third parties caused the mistake.

3. The taxpayer is diligent in requesting the revocation.

4. Tax avoidance is not the only reason.

Planning To Elect Out

It may be advantageous to elect out of installment reporting. Occasions when installment reporting should be considered include:

1. The taxpayer has NOL carryforwards and/or capital loss carryforwards.

2. The taxpayer is carrying forward suspended investment interest expense. In this case by reporting the capital gain in full an election may be made to treat the capital gain as ordinary income so it may be used as investment income for purposes of claiming the investment interest expense deduction.

3. The taxpayer has unused carryforward tax credits.

4. Social Security Reporting Implications, i.e. reporting on an installment sale basis causes AGI to be increased each year by the installment payment and thus the taxation of Social Security Income. Including the gain all in one year only affects AGI in that year and may preclude the taxation of Social Security Income in the future.

An election out of Installment sale reporting is made by simply reporting the full capital gain on Schedule D or form 4797.

Certain closely related parties may not use the installment sale method for sales of depreciable property (§453(g)). All payments to be received are deemed received in the table year in which the sale occurs. This rule is intended to deter transactions which are structured to give the related purchaser the benefit of depreciation deductions (measured from a stepped-up basis) before the time the seller has to include in income the corresponding gain on the sale.

Calculating the Installment Gain

The gross profit percentage determines how much of each principle payment is currently included in income.

1. The profit percentage is the ratio of the total profit to the contract price. The contract price is the amount the seller will actually receive (unreduced by selling expenses.)

2. Payments received include the down payment (unreduced by selling expenses), all other principal payments and any other property received except for the evidence of indebtedness.

3. Mortgages assumed or taken subject to by the buyer are considered payments in the year of sale to the extent the mortgages exceed the basis of the property sold. The excess of mortgage over basis is included in the computation of the contract price.

4. For sales of recovery or depreciable property resulting in depreciation recapture, the amount of gain that is recaptured under §1245 including §179 expense) and §1250, is fully taxable as ordinary income in the year of sale.

    a. For personal property, all depreciation taken is recaptured as ordinary income to the extent of gain.

    b. For real property, generally the excess of accelerated over straight line depreciation is recaptured as ordinary income. For ACRS commercial real property, all depreciation is recaptured if an accelerated method was used.

Remember: Remaining depreciation (not excess) is taxed at 25% rather than 15%.

Allocating Capital Gain on Installment Sale of Real Property

"Front-loaded" method to be used: The proposed regulations provide that when the capital gain from an installment sale consists of both 25%-rate gain and 15%-rate gain, then, as payments are received, the 25%-rate gain is taken into account before any 15%-rate gain is included. If part of the capital gain from an installment sale is from unrecaptured §1250 depreciation (25% rate), the taxable portion of the payments received are considered **first** to be from the unrecaptured §1250 depreciation. Once all unrecaptured §1250 depreciation is taxed, the balance of the installment sale payments is considered to be adjusted net capital gain (15% rate.) [Prop. Reg. §1.453-12(a)].

> **Comment:** This means that if the total gain recognized from the sale is less than the 25%-rate gain, then none of the gain will be taxed as 15%-rate gain.

Prior year installment sale collections: Payments received from a prior year installment sale are taxed assuming that all payments received prior to the law change were first taxed as unrecaptured §1250 depreciation. Thus, if the taxable gains reported in prior years exceed the amount of unrecaptured §1250 depreciation on the property, subsequent gains are taxed at the 15% rate. If the taxable gains reported in prior years do NOT exceed the amount of unrecaptured §1250 depreciation on the property, subsequent gains are taxed first at the 25% rate until the total taxable amount equals the unrecaptured §1250 amount.

Installment Sale Examples

Dennis, in the above example decides to sell his apartment building in an installment sale. Examples A and B calculate the current year taxable income using the following sale assumptions:

	A	**B**
Dennis' loan assumed by buyer	$ 0	$300,000
Down payment	350,000	50,000
Dennis carries note	150,000	150,000
Total sales price	$500,000	$500,000

Gain and related tax is shifted to future years as follows:

	A	**B**
Gain in Year of Sale	$115,500	$41,249
Gain in Future Years	49,500	123,751
Total Gain	$165,000	$165,000

Results:

Tax on A

Gain in Year of Sale	$115,500	
1250 Recapture	105,000 x 25%	$26,250
	10,500 x 15%	1,575
		$27,825

Tax on B

Gain in Year of Sale	$41,249	
1250 Recapture	41,249 x 25%	$10,312

Form **STATEMENT**

In Support of
COMPUTATION OF SALE
SECTION 1245 OR 1250 PROPERTY

Tax Year **19**

Taxpayer: DENNIS

Tax ID No: 111-11-1111

Date:

Property Description: APARTMENT
Date Of Sale:

COMPUTATION OF GAIN OR LOSS ON SALE		
Total Months Held	124	
Gross Sales Price		500,000
Cost Or Other Basis	405,000	
Depreciation Allowed Or Allowable	-105,000	
Expense Of Sale	35,000	
Adjusted Basis And Cost Of Sale		335,000
Net Gain Or Loss (-)		165,000
SECTION 1245 GAIN ALLOCATION		
Depreciation Taken before 1962	0	
Ordinary Income Portion		0
Section 1231 Gain or Loss		0
SECTION 1250 GAIN ALLOCATION		
200 Month Rule Factor	0.00	
Excess Depr After 1975 (76 for CA)	0	
Excess Depr 1970 thru 75 (71-76 CA)	0	
Ordinary Income Portion		0
Section 1231 Gain or Loss		165,000
INSTALLMENT SALE COMPUTATION - YEAR OF SALE		
Contract Price		500,000
Payments In Year Of Sale	350,000	
Excess Of Mortgage Over Basis	0	
Total Received In Year Of Sale	350,000	
Profit Percentage - Year Of Sale	33.00	
Taxable Gain In Year Of Sale		115,500
Ordinary Income Portion	0	
Section 1231 Gain	115,500	
INSTALLMENT SALE COMPUTATION - SUBSEQUENT YEARS		
Face Value Of The Seller's Note	0	
Seller's Basis In The Property	0	
Gain Recognized In Year Of Sale	0	
Payments In Year Of Sale	0	
Profit Percentage - Subsequent Years...............		33.00
Taxable In Subsequent Years		49,500
Ordinary Income Portion	0	
Section 1231 Gain	49,500	
Allocable Installment Indebtedness (AII)		0

Diagnostics:
Note: using 1250 accelerated depreciation, no excess shown.

Form TATEMENT	In Support of TAX DEFERRED EXCHANGE OF PROPERTY (CODE SECTION 1031)	Tax Year 19

Taxpayer: DENNIS

Tax ID No: 111-11-1111

Date: 10/21/97

Date Acquired:
Date Exchanged: ---

BASIS OF PROPERTY CONVEYED			
1 Cost/Basis of Property Conveyed		405,000	
2 Depreciation Allowed/Allowable		105,000	
3 Adj. Basis of Property Conveyed			300,000
REALIZED GAIN			
4 Fair Market Value of Property Received.	450,000		
5 Cash Received	0		
6 Fair Market Value of Boot Received	60,000		
7 Mortgage Balance on Property Conveyed .	300,000		
8 Total Consideration Received		810,000	
(LESS:)			
9 Adjusted Basis of Property Conveyed ...	300,000		
10 Cash Given	0		
11 Adjusted Basis of Boot Conveyed	0		
12 Mortgage Assumed on Property Received .	310,000		
13 Exchange Expenses	35,000		
14 Total Consideration Given		645,000	
15 Gain Realized on the Exchange			165,000
RECOGNIZED GAIN			
16 Cash & Boot Received	60,000		
17 Cash & Boot Conveyed	0		
18 Exchange Expenses	35,000		
19 Net Cash & Boot Received (can be negative)		25,000	
20 Mortgage on the Property Conveyed	300,000		
21 Mortgage Assumed on Property Received .	310,000		
22 Net Mortgage Relief		0	
23 Gain Recognized			25,000
BASIS OF NEW PROPERTY			
24 Adjusted Basis of Property Conveyed ...	300,000		
25 Cash or Boot Conveyed	0		
26 Mortgage Assumed on Property Received .	310,000		
27 Total		610,000	
28 Cash & Boot Received	60,000		
29 Mortgage on Property Conveyed	300,000		
30 Total		360,000	
31 LINE 27 LESS LINE 30		250,000	
32 GAIN RECOGNIZED ON EXCHANGE		25,000	
33 Exchange Expenses		35,000	
34 BASIS OF NEW PROPERTY			310,000

C. Tax Deferred Exchanges

Revenue Procedure 2008-16

This Revenue Procedure provides a safe harbor (as like-kind property) for dwelling units that taxpayers hold primarily for the production of current rental income but also use the properties occasionally for personal purposes.

The IRS will not challenge whether a dwelling unit qualifies as property held for productive use in a trade or business or for investment purposes if the following requirements are met:

The dwelling unit (defined as real property improved with a house, apartment, condominium or similar improvement that provides basis living accommodations including sleeping space, bathroom and cooking facilities) meets the following qualifying use standards;

Relinquished Property

The dwelling unit must be owned by the taxpayer for at least 24 months immediately before the exchange (the "qualifying use period") and

> Within the qualifying use period, in each of the two 12 month periods immediately preceding the exchange:
>
> a. The taxpayer rents the dwelling unit to another person or persons at a fair rental value for 14 days or more, <u>and</u>
> b. The period of the taxpayer's personal use of the dwelling unit does not exceed the greater of 14 days or 10 percent of the number of days during the 12 month period that the dwelling unit is rented at a fair rental value.
>
> > **Note:** For this purpose, the first 12 month period immediately preceding the exchange ends on the day before the exchange takes place (and begins 12 months prior to that day) and the second 12 month period ends on the day before the first 12 month period begins (and begins 12 months prior to that day).

Replacement Property

A dwelling unit that a taxpayer intends to be replacement property in a §1031 exchange qualifies as property held for productive use in a trade or business or for investment if:

> a. The dwelling unit is owned by the taxpayer for at least 24 months immediately after the exchange (the "qualifying use period"); and
>
> b. Within the qualifying use period, in each of the two 12 month periods immediately after the exchange, the taxpayer rents the dwelling unit to another person or persons at a fair rental for 14 days or more, and

c. The period of the taxpayer's personal use of the dwelling unit does not exceed the greater of 14 days or 10 percent of the number of days during the 12 month period that the dwelling unit is rented at a fair rental.

> **Note:** For this purpose, the first 12 month period immediately after the exchange begins on the day after the exchange takes place and the second 12 month period begins on the day after the first 12 month period ends.

For purposes of this Revenue Procedure, personal use of a dwelling unit occurs on any day on which a taxpayer is deemed to have used the dwelling unit for personal purposes under §280A(d)(2).

Moore vs. Commr **T.C. Memo 2007-134-What Doesn't Work!**

Notwithstanding Rev. Proc. 2008-16, it is not possible to do a §1031 exchange of vacation property which has been used entirely for personal use for another such property. In *Moore*, the taxpayers owned property on a lake that they used for various recreational purposes including swimming, boating and fishing. The deducted the interest expense on the property as second home interest. Several years later they exchanged this property for similar property closer to their home. Neither property was ever rented out. The taxpayers claimed it was investment property as they were holding it for appreciation in value.

The court said:

> "The taxpayers point to their interest in the appreciation potential of the two properties, both before and after acquisition and argue: If investment intent is one motive for holding property, it is held for investment purposes under §1031. The taxpayers' argument, if carried to its logical extreme, is that the existence of any investment motive in holding a personal residence, no matter how minor a factor in the overall decision to acquire and hold (or simply to hold) the property before its inclusion in an exchange of properties, will render it 'property….held for investment with any gain on the exchange eligible for nonrecognition treatment under §1031.' The taxpayers' are mistaken. It is a taxpayers' <u>primary</u> purpose in holding the properties that counts ….
>
> As a preliminary matter, we accept as a fact that the taxpayers hoped that both of the properties would appreciate. However, the mere hop or expectation that property may be sold at a gain cannot establish an investment intent if the taxpayer uses the property as a residence. Moreover, a taxpayer cannot escape the residential status of property merely by moving out … The taxpayer must be seeking to realize a profit representing post conversion appreciation in the market value of the property. Clearly, where the profit represents only the appreciation which took place during the period of occupancy as a personal residence, it cannot be said that the property was "held for the production of income".

> The judge further said: "Taxpayers would have us believe that they used the house only as a caretaker's cottage while awaiting the expected appreciation in the value of the property as a whole. While awaiting that event, however, they purchased a 6-to 8-passenger motorboat to pass the time on the lake."

Finally there was inconsistent reporting that weighed against the Moores. If the vacation home is truly held for investment, any interest expense should be deducted on Schedule A as investment interest and not as second home interest.

1. Depreciation On Property Received In Exchange

TEMP REGS. §§1.168-(a)-1T, (b)-1T, (d)-1T(i)-6T, and (k)-1T (TD 9115)

In March of 2004, the IRS issued new temporary regulations explaining how to depreciate assets acquired in §1031 (like kind exchanges) or §1033 (involuntary conversions). These rules apply to like-kind exchanges and involuntary conversions of MACRS property for which the time of disposition and the time of replacement both occur after 02/27/04. There is also a special provision that allows these rules to apply retroactively. Taxpayers should consider filing amended returns if a tax advantage would result for any open year.

Finally there is incorporated in the regulations a provision that allows for electing out of these rules entirely and simply depreciating replacement property as if it is newly acquired MACRS property that is placed in service at the time of the replacement. There will be transactions where tax will be saved by opting out of these rules and there also may be instances when the complexities of the rules themselves make opting out the method of choice.

Definitions

Exchanges Basis

The exchanged basis is the basis of the relinquished property after calculating year of disposition depreciation.

Excess Basis

Excess basis is the amount of additional cash or property that is paid for the replacement property in addition to the relinquished property.

General Rule

The general rule is used when the replacement property ahs the same or shorter recovery period or the same or faster depreciation method. In such circumstances, the basis of the relinquished property (exchanged basis) will be depreciated using the remaining recovery period, and the same depreciation method and same convention as was used prior to exchanging it. In other words, to the extent of the exchanged basis, depreciation is calculated just as before the exchange.

The excess basis of the replacement property is depreciated as a new purchase using the applicable MACRS depreciation, recovery period, and convention.

Example

John exchanges a residential rental house he purchased in January 2000 with an exchange basis of $250,000 for an apartment building for which he pays $500,000 in January of 2008.

Since the apartment building has the same recovery period and depreciation method as the residential rental house, John will continue to depreciate the exchange basis of $250,000 over the remaining recovery period of 19½ years. The excess basis amount ($250,000) will be separately depreciated starting with January of 2008 (date placed in service) beginning a new 27½ year recovery period.

Exception to General Rule

The general rule does not apply if the replacement property has a longer recovery period or requires a slower method of depreciation than the relinquished property. In such cases the exchanged basis is depreciated over the remainder of the longer period that would have applied if the replacement property had originally been placed in service when the relinquished property was placed in service. The same rule applies if the depreciation method used on the relinquished property was faster than the method required to be used on the replacement property. In such a case the replacement property's exchanged basis amount must be depreciated using the slower method that would have applied if the replacement property had originally been placed in service when the relinquished property was placed in service.

Example

Same facts as above example only John exchanges the residential rental house for a commercial office building. Because the commercial office building requires a longer recovery period of 39 years the replacement building's exchange basis is treated as placed in service in January 2008. Depreciation on the exchange basis is calculated using 39 years less the 8 years already used prior to the exchange or 31 years. The excess basis ($250,000) is treated as a purchase from January 2008 using the required MACRS recovery period of 39 years.

> **Note**: If the taxpayer is doing a non-simultaneous exchange, i.e., a deferred exchange, the basis of the relinquished property after disposition may not be depreciated until the acquisition of the replacement property is complete. Depreciation recovery period is suspended during this period of time. (§1.168(k)-6T(c)(5)(iii)).

Electing Out

Taxpayers may elect out of using the above rules. In some cases following the general rule above does not result in the best tax advantage. In cases where the replacement property actually has a shorter recovery period following the general rule results in slower depreciation recovery.

Example

Cash owns a commercial building and exchanges it for a residential real estate property. He has held the commercial building for two years so the remaining recovery period is 37 years. Cash would like to use the shorter recovery period of 27½ years that applies to residential realty so he elects out of the "general rule." Cash may then treat the replacement property as newly acquired property placed in service at the time of the replacement.

The election must be made for each 1031 or 1033 transaction for which the taxpayer wishes to elect out of. The election is made by typing or legibly printing, at the top of Form 4562 "ELECTION MADE UNDER §1.168(I)-6T (i) or in the manner provided on Form 4562. The deadline for the election is the due date of the return including extensions for the year the replacement property was placed in service.

D. Rental Of Residence

THE §280A DISALLOWANCE RULES

> *"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."* (§280A)

In the case of a rental also used as a residence, deductions are allowed first to the extent that they would have been allowed regardless of the rental use (for example, property tax) and then to the extent of net income reduced by otherwise allowable deductions above.

> **Carryover**: Any amount not allowable as a deduction due to these rules may be carried over to the succeeding taxable year.

> **Warning**: If the rental activity is deemed not to be engaged in for profit, the hobby loss rules provide that expenses are deductible to the extent of income but only as itemized deductions. Furthermore, there is no carryover of disallowed losses. This treatment makes the hobby loss rules even more detrimental than the §280A loss disallowance rules above.

This disallowance section applies to many frequently encountered situations including:

- The rental of a portion of the taxpayer's principal residence,
- The rental of the taxpayer's residence for a portion of the year, and
- The vacation home with some personal use.

If a home is converted to a rental, the loss disallowance rules do not apply. Specifically, rental losses are <u>not denied</u> if the dwelling is rented at fair market value.

- For a consecutive period of 12 months or more which begins or ends in the tax year, or
- For a consecutive period of less than 12 months if the rental is sold at the end of the period (§280A(d)(4)).

E. Personal Use Of Vacation Homes And Other Dwelling Units

The calculation of rental income and deductions depends on how much personal use was made of the property and how many days the property was rented. Rental income is always included in income with the exception of the dwelling unit that is rented less than 15 days. Expenses are divided between personal use and rental use based on the number of days the property was used for each purpose.

Not too much personal use. If the dwelling unit was not used as a residence, the deductible rental expenses can be more than gross rental income – in other words, the rental can result in a deductible loss!

> **Warning**: Such losses may be limited by the passive activity rules discussed later.

Too much personal use. If there is net profit from the rental property for the year (that is, rental income is more than total rental expenses, including depreciation), than all rental expenses are deductible. However, if expenses exceed income, the net loss is denied.

> **Planning**: In the case of too much personal use, the dwelling may qualify as a second home for purposes of deducting home mortgage interest. In some instances it may be better to flunk the personal use test and deduct the mortgage interest attributable to the personal use as interest on a second home.

The rules Apply to *Dwelling Units*

The §280A loss disallowance rules apply to vacation homes and other *dwelling units*. A dwelling unit includes a house, apartment, condominium, mobile home, boat, or similar property. A dwelling unit has basic living accommodations, such as sleeping space, a toilet, and cooking facilities. A dwelling unit does not include property used solely as a hotel, motel, inn, or similar establishment.

Property is used solely as a hotel, motel, inn, or similar establishment if it is regularly available for occupancy by paying customers and is not used by an owner as a home during the year.

Example

Sam rents out a room in his home that is always available for short-term occupancy by paying customers. He does not use the room himself and allows only paying customers to use the room. The room is used solely as a hotel, motel, inn, or similar establishment and is not a dwelling unit.

When is a Dwelling Unit Used as a Residence?

Time test. A dwelling unit is considered used as a residence if it is used for *personal purposes* for the greater of:

1. 14 days, or

2. 10% of the number of days it is rented at fair market value.

> **For Example:** A mountain cabin rented for 160 days during the year will not be considered used as a residence if personal use is 16 days or less.
>
> **Note:** If a dwelling unit is used for personal purposes on a day it is rented at a fair rental price, that day is not counted as a day of rental in applying 2 above. Instead it is counted as a day of personal use in applying both 1 and 2 above.

Repair and maintenance days are not personal use days. Any day spent working substantially full time repairing and maintaining the property is not counted as a day of personal use. Such a day does not count as a day of personal use even if family members use the property for recreational purposes on the same day.

Personal purposes. A taxpayer is deemed to have used a dwelling unit for personal purposes for a day if, for any part of such day the unit is used:

1. For personal purposes by the taxpayer or any other person who has an interest in such unit (except under a shared equity financing agreement),

   Timeshare: Use by other owners in a timeshare situation was considered personal use by the taxpayer (*Fudim*, TC Memo 1994-235).

   Shared equity: Rental to a person having an equity interest in the property will not be considered personal use by the taxpayer only if the rental is under a "shared equity financing agreement" (§280(d)(3)(B)(i)). A "shared equity financing agreement" is an agreement under which two or more persons acquire a "qualified ownership interest" in a dwelling unit and the person holding one or more qualified ownership interests is entitled to occupy the unit as a principal residence and is required to pay rent to one or more of the non-occupying co-owners. A fair rental under such an arrangement is determined at the time the shared equity financing agreement is entered into and takes into account the occupant's qualified ownership interests (§280A(d)(3)(B)(ii)).

2. By a family member or a family member of any other person who has an interest in such unit unless the family member uses the dwelling unit as his or her main home and pays a fair rental price,

   Family: Family includes only brothers and sisters, half-brothers and half-sisters, spouses, ancestors (parents, grandparents, etc.) and lineal descendants (children, grandchildren, etc.).

3. By any individual who has swapped units with the taxpayer, or

4. By any individual at less than fair market value rent (§280A(d)(2).

The donation of the use of home to a charitable organization is considered personal use if the organization sells the use of the home at a fund-raising event and the purchaser uses the unit.

Examples

1. John rents the basement of his home which he has converted to an apartment to college students during the regular school year on a 9-month (273 days) lease. During the summer, his brother stays with him for a month (30 days) and lives in the apartment rent free. John's basement apartment is used as a home because it is used for personal use for 30 days. That is more than the greater of 14 days or 10% of the total days it is rented.
2. Sharon and Roberta are co-owners of a condominium at the beach. Sharon rents the unit out to vacationers whenever possible. The unit is not used as a main home by anyone. Roberta uses the unit for 2 weeks every year. Because Roberta has an interest in the unit, both Sharon and Roberta are considered to have used the unit for personal purposes during those 2 weeks.

3. Vern owns a rental property that he rents to his son Corey. Vern's son has no interest in this dwelling unit (or anything else!). Corey uses the property as his main home and pays Vern a fair rental price for the property. Vern's son's use of the property is not personal use by Vern because his son is using it as his main home, he has no interest in the property, and he is paying fair rental price.