Today's Real Estate Tax Issues & Strategies

Presented by: Karen Brosi

Western CPE
243 Pegasus Drive
Bozeman, MT 59718
(800) 822-4194
Fax: 206.774.1285
Email: wcpe@westerncpe.com
Web: www.westerncpe.com

Course CPE Information

Field of Study
Taxes. Some state boards may count credits under different categories—check with your state board for more information.

Course Level
Intermediate

Prerequisites
Basic knowledge of tax planning.

Advance Preparation
None.

Course Description
The real estate market has bounced back some since the major collapse in the recession, but its future is still unclear. Congress keeps tweaking tax rules surrounding ownership and sales of real property, keeping everyone a bit unsure about future directions and tax implications. In this course you will review a medley of complicated real estate-related topics, including several of the most potentially troublesome areas. After taking this course, you'll take home valuable planning strategies for you and your clients.

Learning Objectives

Course learning objectives clearly define the knowledge, skills, or abilities you will gain by completing the course.

After completing this course, you will be able to:

- Properly apply tax treatment of vacation homes and second residences
- Advise on what happens to suspended losses when a taxpayer dies or gifts or converts rental property
- Apply techniques for Sec. 1031 exchanges and the Sec. 121 exclusions
- Apply home office rules
- Advise on foreclosure and debt cancellation

TODAY'S REAL ESTATE TAX ISSUES & STRATEGIES

Together with the related lecture this handout is designed to provide accurate and authoritative information about complex areas of tax law. But, the information contained in this manual may change as a result of new tax legislation, Treasury Department regulations, Internal Revenue Service or Franchise Tax Board interpretations, or judicial and state agency interpretations of existing tax law. This manual is not intended to provide legal, accounting, or other professional services and is provided with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional services.

This manual and related lecture should not be used as a substitute for professional advice. If legal advice or other expert assistance is required, the services of a competent tax advisor should be sought.

From a Declaration of Principles jointly adopted by a Committee of the American Bar Association and a committee of Publishers and Associations.

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More Questions Than Answers

There are always more questions than answers because we must deal with the ever changing rules for real estate tax issues. Most of our clients own homes so mortgage interest and home sale questions are common. More recently, falling prices in the home sale market have left us with endless client questions regarding the taxes on foreclosures and loan modifications. Investments in real estate have been a path to wealth in the past. Today a rental property's negative cash flow may result in questions about passive activity rules, real estate professional qualifications and, maybe, how foreclosures are taxed. If the property owner has a gain, often acquired through long term ownership, exchanges and installment sales are a topic of conversation. In this seminar, we will work on the answers to the following "quick client questions."

I Have a Quick Question

- I'm already drowning in paper work. Do I really have to do 1099s for the gardener and painter I use for my rental? Do I have to give my social security number on a 1099 to a wandering handyman?
- I haven't been audited in a really long time. Am I just lucky?
- Should I buy or rent?
- Should I help my child buy a house?
- I have a big loss on my home. If I convert it to a rental, can I deduct the loss at sale?
- Who's going to know if my home acquisition debt loan exceeds $1 million?
- Who's going to know if my home equity borrowing exceeds $100,000?
- If I make the payments, can I deduct interest on my Dad's house?
- If I borrow from my stock account to buy a vacation home, can I deduct the interest?
- Can I borrow from my home and buy a rental with the proceeds? Where is the mortgage interest deductible?
- If my sister and I own a home together, can we each deduct interest on a $1 million acquisition indebtedness?
- Can I claim a home office for managing my rentals?
- Do I have to be married for two years before I sell my personal residence in order to exclude a $500,000 gain?
- If I own half of the home, do I only qualify for half of the $250,000 exclusion?
- Can I exclude the gain on my personal residence if I rent it for two years after I move for retirement?
- Can I exclude the gain on the sale of a home that I rented for several years and then lived in for three?
- Do I pay tax if my rental property is foreclosed?
- Do I pay tax if my house is foreclosed?
- My house is selling for less than the loan. Do I pay tax at the sale?
- How is COD computed if my house is foreclosed and I have an equity loan forgiven?
- Is there a difference in the COD calculation if I have a recourse or non recourse loan on the property foreclosed?

- I have both a recourse and a non recourse loan on my property. How do I report the foreclosure?
- I exchanged into a rental property that is now being foreclosed. How is it possible that I have lost my property and I still owe tax?
- Where is COD reported?
- Can I get out of paying tax on COD?
- Do the passive loss rules apply to me?
- Can I sell on an installment sale if my loan is more than my basis in the property being sold because of refinances?
- Can I buy a rental property to get more tax deductions?
- Can I deduct the losses on my vacation rental?
- Can I qualify as a real estate professional?
- Is my recordkeeping enough to prove I am a real estate professional?
- Can I work as an engineer and still be a real estate professional?
- How important is the aggregation election in proving that I am a real estate professional?
- Can I aggregate my vacation rental into my apartment building rentals?
- Will I ever get to use my suspended passive losses? Who gets them if I die?
- Is an installment sale good for me?
- When is an installment sale bad? Shall I elect out of the installment sale?
- Do I get a tax benefit if I buy a rental to use for my incorporated law practice?
- I have a large gain on my rental building. Is an exchange good for me? What's bad about an exchange?
- Does my exchange qualify for tax deferral? Did I get constructive receipt of the sales price?
- Is the target property like-kind in the exchange? What is like-kind property?
- Who can be an intermediary in a delayed exchange? Can I trust them with my money?
- Can I exchange my rental for my Mother's house?

Real Estate Tax News

Congress Repeals Expanded 1099 Reporting (The Comprehensive 1099 Taxpayer Protection and Repayment of Exchange Subsidy Overpayments Act of 2011)

The Comprehensive 1099 Taxpayer Protection and Repayment of Exchange Subsidy Overpayments Act of 2011 was signed into law by President Obama on April 14, 2011. The legislation repeals two controversial Form 1099 reporting provisions that would have required (1) landlords to issue Forms 1099 to service providers paid $600 or more in a year and (2) all businesses that paid $600 or more to a corporation for goods and services to file a Form 1099 on the payments.

Treasury Tells IRS To Increase Rental Real Estate Audits (TIGTA Report 2011-30-005)

A Treasury Inspector General for Tax Administration (TIGTA) report from August 2008 found that at least 53% of individual taxpayers with rental real estate activity for Tax

Year 2001 misreported their rental real estate activity, resulting in an estimated $12.4 billion of net misreported income. Because of its 2008 findings, TIGTA revisited the subject. According to the 2011 audit report, the IRS is strongly encouraged to increase its examinations of individual tax returns that report losses from rental real estate activities. IRS management agreed with all of TIGTA's recommendations.

TIGTA also found that during Fiscal Years 2008 and 2009, the IRS's rental real estate Compliance Initiative Program (CIP) examined only a small percentage of the 318,339 examinations conducted by revenue agents and tax compliance officers. TIGTA projected that if the IRS increased the percentage of rental real estate CIP tax returns it examined, it could increase the potential tax assessments by $27.3 million over a five-year period.

TIGTA/IRS Estimates Amount of Tax Gap Created by Taxpayers Erroneously Reporting Real Estate Income/Expenses and Real Estate Professional Status (TIGTA Report 2011-30-005)

Of the $345 billion annual tax gap, the IRS estimates that individuals underreported their taxes, related to rental real estate, by as much as $13 billion. TIGTA's sample results showed taxpayers claiming to be real estate professionals deducted approximately $5 million in rental real estate activity losses that were not subject to further examination.

Practitioner Point. More IRS audits are on their way. Review with your real estate professionals the rules and the recordkeeping requirements. More on this later.

Form 8582 Must be Filed Even When Passive Activity Reports Net Income

The instructions for Form 8582 inform all taxpayers that Form 8582 must be filed by taxpayers who have an overall gain (including any prior year unallowed losses) from business or rental passive activities.

Schedule E Redesigned to Highlight Potential Audit Areas

Property type now required. The passive activity loss rules severely restrict deductions from rental activities. Certain types of property are subject to stricter limitations than others. The redesigned Schedule E now requires taxpayers to identify the type of property that is being rented (i.e., single family residence, multi family residence, vacation home, commercial, land, royalties, self rental, and other). This is in addition to providing the complete physical address.

> ***Preparer Note.*** This additional information is designed to prevent avoidance of the passive loss, self-rental recharacterization and the vacation home rules.

Personal Residence

Helping a Child Buy a House

House prices have dropped but the price may still be too high for your child to achieve the American dream of owning a home. So how does Mom or Dad help with the purchase of their child's first home?

Planning Points for Helping a Child Buy a Home
1. **Give them money for a down payment.** Watch for gift tax reporting if the gift exceeds $14,000/ $28,000. 2. **Lend them money for the down payment.** Gift loan rules apply and interest may have to be charged and paid to comply with IRS rules. Secure the loan to the property to give the child a mortgage interest deduction and you a better chance for repayment. 3. **If you don't have cash, you can borrow** from your home or other assets to come up with the cash to give or lend. But someone has to make those payments, so make sure you are able to service the loan whether junior pays or not. 4. **Buy the house with the child.** Use your credit to get a better and bigger loan. However if the child defaults on the mortgage, your credit may go into the dump along with his/hers.

Interest on Loan From Family Must be Perfected to Deduct Interest

Yong Dong bought a home in New York in 2005. Yong entered into a loan agreement in 2007 with his parents that allowed Yong to borrow up to $130,000. The loan agreement stipulated that Yong's interest in his home was the specific security for the payment of the debt. Although Yong and his parents had a written loan agreement and a deed of trust, neither document was recorded in any jurisdiction.

Yong deducted interest he paid to his parents of $26,442 and $26,162 on his 2007 and 2008 tax returns, respectively. The IRS accepted that the loan agreement between Yong and his parents provided that Yong's New York home was specific security for the payment of the loan. The IRS, however, disallowed the mortgage interest deductions because neither the loan agreement nor the deed of trust were properly secured under state law.

The Court ruled that, in the event of a default, Yong's unrecorded mortgage would not be sufficient to subject his residence to the satisfaction of the debt with the same priority as a recorded mortgage because the unrecorded mortgage is valid only against a third person having actual notice of it. The Court further determined that neither the deed of trust nor the loan agreement between Yong and his parents were perfected under New York state law and ruled the interest he paid to his parents was not deductible (*Yong J. Dong v. Comm.*, TCS 2014-4).

> ***Planning Point.*** If your client says his dad lent him money to buy a house, check to see that the note is recorded or the interest that Son paid to Dad will not be

> deductible. If your client says that he has interest income to report because he lent his son money to buy a house, remind the client that unless the loan is recorded against the house, the interest is not deductible for Son, but still taxable to Dad.

Financing the Purchase

Home Mortgage Interest

Generally, interest paid on loans used for personal purposes is not tax deductible (§163(h)(2)). The major exception is that personal interest is allowed as a deduction on Schedule A for mortgage interest paid on a qualified residence loan. In order to qualify, the taxpayer must have a qualified residence and qualified indebtedness. The loan may be a mortgage to buy the home, a second mortgage, a line of credit, or a home equity loan. In addition the:

1. taxpayer must file Form 1040 and itemize deductions on Schedule A;
2. taxpayer must be legally liable for the loan. Payments are not deductible if they are made for someone else or if the taxpayer is not legally required to make them. Both the taxpayer and the lender must intend that the loan be repaid and there must be a true debtor-creditor relationship; and,
3. mortgage debt must be secured by a qualified home.

What Exactly is a Qualified Residence?

To take a home mortgage interest deduction, the debt must be secured by a "qualified residence." This means either a principal residence (as defined under §121) or one other residence of the taxpayer that is selected by the taxpayer for purposes of §163(h) and that is used by the taxpayer as a residence (within the meaning of §280A(d)(1)) (§163(h)(4)(A)(i)). If the taxpayer owns more than two residences, only interest paid on two may be deducted in any given year. A residence may include a house, condominium, cooperative, mobile home, house trailer, boat, or similar property that has sleeping, cooking, and toilet facilities (Reg. §1.163-10T(p)).

> ***Planning Point.*** Interest paid on a mortgage for a home other than a taxpayer's main or second residence may still be deductible if the proceeds of the loan were used for a deductible purpose other than home mortgage interest (e.g., business, investment, rental activities, etc.). Otherwise, the interest paid is considered personal interest and is not deductible. See discussion of interest allocations below.

Interest paid on the main residence or second home is deductible. A taxpayer can have only one main residence at any one time and it will ordinarily be where he or she lives the majority of the time (Reg. §1.163-10T(p)(2)). A second home is a home that the taxpayer chooses to treat as his or her second home. A taxpayer cannot have more than one second residence at a time (Reg. §1.163-10T(p)(3)).

For taxpayers with more than one second home, only one may be treated as the qualified second home during any year (§163(h)(4)(A)(ii). However, the determination of a second home is made annually and the taxpayer may not elect different residences as second residences at different times during the year, except if the (§1.163-10T(p)(3)(iv)):

1. taxpayer buys a new home during the year, the taxpayer can choose to treat the new home as the second home as of the day the taxpayer bought it.
2. taxpayer's main home no longer qualifies as the main home, the taxpayer can choose to treat it as his or her second home as of the day the taxpayer stopped using it as a main home.
3. taxpayer's second home is sold during the year or becomes his or her main home, the taxpayer can choose a new second home as of the day the old one sold or the taxpayer began using it as his or her main home.

For a home used for more than one purpose, only the part used for residential living is considered a "qualified home". If the taxpayer uses part of the home for other than residential living, such as a home office, home use, and the corresponding interest deduction, is allocated on a pro rata basis (Reg. §1.163-10T(p)(4)(I)). For example, if the taxpayer uses a portion of his or her home as an office for their business, that portion of the property does not qualify as a residence.

Special rules apply if part of a residence is rented. In these situations, a taxpayer must treat the rented part as being used by the taxpayer for residential living only if three conditions apply:

1. The rented part of the home is used by the tenant primarily for residential living;
2. The rented part of the home is not a self-contained residential unit having separate sleeping, cooking, and toilet facilities; and,
3. The same or different parts of the home are not rented (directly or by sublease) to more than two tenants at any time during the tax year. If two persons (and dependents of either) share the same sleeping quarters, they are treated as one tenant.

Example. Sara rents out a bedroom to her friend Joy. The bedroom does not have separate cooking facilities. As such, assuming all other rules are met, Sara is not required to prorate. All of her mortgage interest is deductible on Schedule A.

Questions are created for homes under construction. Taxpayers are allowed to treat a home under construction as a qualified home for a period of up to 24 months, but only if it becomes the taxpayer's qualified home at the time it is ready for occupancy. The 24-month period can start any time on or after the day construction begins (Reg. §1.163-10T(p)(5)(ii)).

> ***Example.*** Jean owns a residential lot suitable for the construction of a vacation home. On April 20, 2008, she obtains a mortgage secured by the lot and any property to be constructed on it. On August 9, 2008, Jean begins construction of a residence on the lot. The residence is ready for occupancy on November 9, 2010. The residence is used as a residence within the meaning of §1.163-10T(p)(3)(iii) during 2010 and Jean elects to treat the residence as her second residence for the period November 9, 2010, through December 31, 2010.
>
> Since the residence under construction is a qualified residence as of the first day that the residence is ready for occupancy (November 9, 2010), Jean may treat the residence as her second residence under §1.163-10T(p)(5)(i) for up to 24 months of the period during which the residence is under construction, commencing on or after the date that construction is begun (August 9, 2008).
>
> If Jean treats the residence as her second residence beginning on August 9, 2008, the residence under construction would cease to qualify as a qualified residence on August 8, 2010. The residence's status as a qualified residence for future periods would be determined without regard to §1.163-10(T)(p)(5)(i).

Qualified homes that are destroyed (fire, storm, tornado or other casualty) continue to be treated as a qualified home. Taxpayers are allowed, subject to certain limits, to continue to deduct the interest paid on the home mortgage on a destroyed home if, within a reasonable period of time after the home is destroyed, the taxpayer (Rev. Rul. 96-32):

1. rebuilds the destroyed home and moves into it; or,
2. sells the land on which the home was located.

This rule applies to a main home and to a second home that is treated as a qualified home.

> ***Planning Point.*** While the term "reasonable period" is not defined in Rev. Rul. 96-32, under §1033(a)(2)(B) a reasonable period for replacement is two years from the end of the year of the casualty, or other period as designated by the Secretary. Accordingly, it seems that a taxpayer would be allowed at least two years to rebuild.

What are the Requirements for Qualified Indebtedness?

In order to satisfy the "qualified indebtedness" requirements of §163(h), the:

1. taxpayer must be legally obligated on the debt;
2. taxpayer must make the payments;
3. debt must be properly collateralized; and
4. total amount of the debt must be within the maximum amount limitations.

The Law - Interest Deductible by Legal "Or Equitable" Owner Only!

Deductible qualified residence interest is defined as any interest paid or accrued during the taxable year on "acquisition indebtedness with respect to any qualified residence of the taxpayer" (§163(h)(3)(A)(i)). This "indebtedness" must, in general, be an obligation of the taxpayer and not an obligation of another (*Golder v. Comm*., 604 F.2d 34, 35 (9th Cir. 1979), affg. T.C. Memo. 1976-150). However, the IRS Regulations provide: "interest paid by the taxpayer on a mortgage upon real estate of which he is the legal ***or equitable*** owner, even though the taxpayer is not directly liable upon the bond or note secured by such mortgage, may be deducted as interest on his indebtedness" (§1.163-1(b)). Where the taxpayer has not established legal, equitable, or beneficial ownership of mortgaged property, the courts generally have disallowed the taxpayer a deduction for the mortgage interest (*Song v. Comm*., T.C. Memo. 1995-446; *Bonkowski v. Comm*., T.C. Memo. 1970-340, affd. 458 F.2d 709 (7th Cir. 1972)).

Look to state law to determine who is owner: State law determines the nature of property rights, and Federal law determines the appropriate tax treatment of those rights (*United States v. Natl. Bank of Commerce*, 472 U.S. 713, 722 (1985)). For example, it is presumed under California law that the owner of legal title is the owner of the full beneficial title. This presumption may be rebutted only by clear and convincing proof.

Prior cases on point: In *Uslu v. Comm*., (T.C. Memo. 1997-551), Mr. and Mrs. Uslu, made mortgage payments on a residence for which legal title was held by Mr. Uslu's brother and sister-in-law. The court found in *Uslu* that the taxpayers "exclusively held the benefits and burdens of ownership," and, therefore, were the equitable and beneficial owners of the residence. However, in *Song v. Comm*., (T.C. Memo 1995-446) where legal title was held by the taxpayer's brother, the court found that the taxpayer failed to prove that she had any equitable or beneficial ownership in the residence. An important distinction between *Uslu* and *Song* was the completeness of the record and the credibility of the legal title holder of the residence: Mr. Uslu's brother and sister-in-law in Uslu, and the taxpayer's brother in Song.

"Burden and benefit" indicators. Listed below are factors used by various tax courts to determine "equitable" ownership.

1. Who has right to possess/use?
2. Who pays property obligations, e.g., taxes?
3. Who pays insurance?
4. Who maintains property?
5. Can property be improved without seller's consent?
6. Who has risk of loss?
7. Must legal title be obtained simply by paying balance of full purchase price?
8. Could "equitable title" be issued under state law? (*Blanche v. Comm.*, TCM 2001-63, affd. 33 Fed. Appx. 704 (5th Cir. 2002))

Equitable Owner Allowed Deduction for Parent's Mortgage

Pat and Mon Ela helped their son, Conrad Edosada, purchase a home in Oakland, CA for $2.15million. Conrad's name was not on title but he did contribute $70,000 towards the $570,000 down payment. Conrad made 100% of the mortgage payments with the understanding that his parents would eventually transfer partial ownership to him. The IRS disallowed Conrad's mortgage interest deduction because he did not own the property that secured the mortgage and thus was not obligated to make the payments.

Court says equitable ownership exists. Conrad testified that he and his parents considered the property to be the family home. He not only resided at the property, but he also bore a substantial risk of loss because he supplied a significant portion of the down payment and he agreed to be responsible for all of the mortgage payments. The Court found that Conrad bore sufficient burdens and benefits of ownership and that he therefore held an equitable interest in the property. He was allowed to deduct mortgage interest as an "equitable owner" although only to the extent of $1.1 million of the mortgage (§1.163(h)(3)(B)(ii)) (*Conrad Edosada v. Comm*., TCS 2012-17).

> ***Planning Point.*** What happens if the owner dies, goes bankrupt or divorces? Maybe it's better to add the co-owners name to title rather than battle in court over equitable ownership.

Mortgage Interest Deduction Denied for Home Owned by Brother

Lourdes Puentes claimed a mortgage interest deduction of $28,942 on her 2009 tax return. However, Puentes was not the legal owner as the house was titled in her brother's name. She argued she was the equitable owner.

The mortgage interest deduction was disallowed since Ms. Puentes offered no evidence that she had any agreement with her brother entitling her to an ownership interest in the home or any beneficial rights, such as the right to rents, the right to profits, the right to possession, the right to improve, or the right to purchase the home (*Lourdes Puentes v. Comm.,* TCM 2013-277).

Action Items for Property Where One Party Is Not on Title
1. Include co-owner's name on title at purchase. This is a good idea but it may not be possible if the co-owner has bad credit and would thus jeopardize the loan. 2. Add co-owner's name to title after purchase. This is a solution but it may not work if adding someone to title calls the loan or results in lots of additional title costs. 3. Engage a real estate attorney to write a valid sales contract (recorded or unrecorded) between the two owners.

Mortgage Must Be Legally Secured and Properly Collateralized

Residence mortgage interest is deductible only if the mortgage is properly secured and collateralized. A secured debt is one in which there exists a signed instrument (such as a mortgage, deed of trust, or land contract) that (§1.163-10T(o)(1)):

1. makes the taxpayer's ownership in a qualified home security for payment of the debt;
2. provides, in case of default, that the home could satisfy the debt; and,
3. is recorded or is otherwise perfected under any state or local law that applies.

A debt will not be considered to be secured by a qualified residence if it is secured solely by virtue of a lien upon the general assets of the taxpayer or by a security interest, such as a mechanic's lien or judgment lien, that attaches to the property without the consent of the debtor.

The collateral must be correct. The specific security requirement compels the correct property be pledged as collateral against the loan *(Boehme vs. Commissioner*, T.C. Memo. 2003-81).

Then there's the case, as reported by the *Wall Street Journal* of former presidential chief of staff John Sununu who purchased a home in Georgetown by borrowing $400,000 secured by his New Hampshire home.

Is this common? Of course. Taxpayers buy vacation homes with loans secured by their primary residences. They borrow out of rental properties to buy second homes. Or, in the case of the Boehmes above, they use other collateral to borrow proceeds to improve their principal residence. All bad planning! All result in ***zero*** deduction!

Planning Points for Borrowing to Buy a Home
1. Interest is limited if the taxpayer borrows from one home and uses the loan proceeds to buy another home. 2. Interest is limited if the taxpayer borrows from his rental property and uses the loan proceeds to buy a home. 3. Interest is limited if the taxpayer borrows from his margin account to buy a home. 4. Interest is limited if the taxpayer pays cash for the home and later wants to borrow money from his home equity.

Wraparound mortgages provide deductible interest. Debt is secured, within the meaning of Treas. Reg. §1.163-10T(o)(1), whenever the security is perfected under state law even if the deed of trust is not recorded where recording is available (FSA 001607 June 1, 1995).

Example: Jim purchased his residence from Jean for $300,000. The residence property had been previously encumbered with two mortgages having "due on sale" clauses. To pay for the house, Jim signed a $300,000 promissory note that was secured by an all inclusive trust deed on the residence. Because neither Jim nor Jean wanted the first and second mortgagees to enforce their "due on sale" clauses, they did not record either the trust deed or the deed. Instead, they delivered both documents to an attorney to hold as trustee. The attorney advised that, under California law, the unrecorded documents constituted a perfected interest and, accordingly, Jim deducted the interest paid on the promissory note as qualified residence interest.

Homeowner Co-Secures Home Loan with Intel Stock And Tries to Deduct Excess as Investment Interest

James and Virginia Ellington purchased a personal residence for $1,578,000 in Albuquerque, New Mexico in 1997. The Ellingtons financed the personal residence purchase with a $1,578,000 loan from Merrill Lynch Credit Corp. The Merrill loan was secured by the personal residence and 8,750 shares of Intel Corporation stock that James owned as an Intel employee. The Intel stock was pledged as security for repayment of the Merrill loan in lieu of a down payment. The Ellingtons refinanced the Merrill loan with a loan from ABN AMRO Mortgage Group, Inc. (ABN) for $1,605,000 ($1,578,000 of the ABN loan proceeds to repay the Merrill loan, and $17,282 of the ABN loan proceeds to pay ABN settlement charges). The ABN loan was secured solely by the personal residence. The Ellingtons deducted a portion of the interest accrued on the Merrill loan and the ABN loan as investment interest for 2006 and 2007. The Ellingtons argued that they may deduct interest accrued on the Merrill loan and ABN loan as investment interest to the extent it was not qualified residence interest and was attributable to the Intel stock. The IRS disallowed the deductions.

Debt and interest are allocated to expenditures according to the use of the debt proceeds. In this case, the Ellingtons paid the entire proceeds from the Merrill loan directly to the sellers for the purchase of their personal residence. Therefore, the full amount of Ellintons' debt was allocated to the personal residence and all of the interest expense accrued on the Merrill loan was allocated to the personal residence (§1.163-8T(c)(1)). The Ellingtons argued that interest accrued on the Merrill loan was allocable to the Intel stock because the Merrill loan was partly secured by the Intel stock. The use of investment property to secure repayment of indebtedness has no effect on the allocation of debt and interest. Rather, it is the "use" of the debt proceeds that determines the allocation. The court held that no interest accrued on the Merrill loan was properly allocable to the Intel stock as investment property (***James and Virginia Ellington v. Comm***., TCM 2011-193).

Election to Treat the Debt as Not Secured by Home

A taxpayer may choose to treat any debt secured by a qualified home as not secured by the home. This treatment begins with the tax year for which the choice is made and continues for all later tax years. The election may be revoked only with the consent of the Internal Revenue Service.

> ***Planning Point.*** Consider treating a debt as not secured by the taxpayer's home if the interest on that debt is fully deductible (for example, as a business expense) whether or not it qualifies as home mortgage interest. This may allow, if other home mortgage limits apply, more of a deduction for interest on other debts that are deductible only as home mortgage interest (§1.163-10T(o)(5)).

Example. Joe owns a principal residence with a fair market value of $375,000 and an adjusted purchase price of $240,000. In 2009, debt A, the proceeds of which were used to purchase the residence, has an average balance of $215,000. The proceeds of debt B, which is secured by a second mortgage on the residence, is allocable to Joe's trade or business under §1.163-8T and has an average balance of $95,000.

In 2010, Joe incurs debt C, which is also secured by Joe's principal residence and which has an average balance of $50,000. In the absence of an election to treat debt B as unsecured, Joe's total mortgages would exceed his acquisition debt by $145,000 ($95,000 debt B plus $50,000 debt C). The result is that only $5,000 of debt C would be qualified mortgage debt for the mortgage interest deduction.

The "10-T" Election

The election to treat debt as not secured by the taxpayer's qualified home should be made in writing.

Sample Election Statement Under Reg. Sec. 1.163-10T(o)(5)

Taxpayer Name: Joe Client
Social Security Number: 999-99-9999
Form: 1040
Tax Year Ending: 12/31/10

The taxpayer elects to treat $95,000 of home equity debt, the proceeds of which were used to purchase equipment and supplies for his business, as trade or business debt.

The interest on this debt for the tax year was $6,175 and is reported on Line 16b of Schedule C.

What if the taxpayer failed to attach the election in writing? Michael D. and Christine R. Alexander incurred credit card debt to purchase equipment for their tree farm. The credit card debt was allocable to a trade or business expenditure (§1.163-8T(b)(7) and (c)(1)). Subsequently, the Alexanders took out a home equity loan, secured by their main home, and used the proceeds to pay off the credit card debt.

The temporary regulations provide that to the extent proceeds of any debt (the "replacement debt") are used to repay any portion of a previously existing debt, the replacement debt is allocated to the expenditures to which the repaid debt was allocated (§1.163-8T(e)(1)). Mr. Alexander credibly testified that he used the proceeds from the home equity loan to repay the credit card debt. The home equity loan was ruled by the tax court to be "replacement debt" and the interest accruing thereon was properly allocable to a trade or business expenditure ***even though the Alexanders did not attach a written election to their returns*** (*Alexander v. Comm.,* T.C. Summary Opinion 2006-127).

New Chief Counsel Advice Changes Way Election to Trace Home Equity Borrowing Works (CCA 201201017)

Reg.§1.163-10T(o)(5) allows the homeowner to elect to trace proceeds from a home loan to his or her use. This is an advantage when the taxpayer uses refinance proceeds for his or her business, investments, rentals, etc. The Chief Counsel Advice clarifies that if an election is made, the entire proceeds of the refinance must be traced to and treated as business, rental or other deductible interest rather than qualified residence interest. If an election is not made, the proceeds are first considered equity borrowing and only the amounts over the $100,000 debt equity limit can be traced.

> ***Preparer Point.*** In the past, we thought that if an election was not made, the interest above the $100,000 equity borrowing amount would be considered personal interest. The CCA clarifies that the interest is directly traced according to the general interest tracing rules in §1.163-8(T). But the CCA also contains a potential trap with the use of the wording "entire proceeds" as illustrated in the third example.

Example. Sharon borrows $150,000 from her home's equity and deposits the proceeds into her business account to pay business bills. She does not include an election under §1.163-10T(o)(5) with her Form 1040. Sharon must allocate interest to Schedule A as home equity borrowing to the extent of $100,000 (assuming she has not already borrowed from her house). The balance of interest can be traced to her Schedule C and deducted as a business interest expense.

Example. Sharon borrows $150,000 from her home's equity and deposits the proceeds into her business account to pay business bills. She includes an election under §1.163-10T(o)(5) with her Form 1040. Sharon can deduct interest on the entire $150,000 loan as business interest expense.

Example. Sharon borrows $50,000 from her home's equity and deposits $30,000 into her business account to pay business bills and uses the remaining $20,000 to pay personal credit card debt. She includes an election under §1.163-10T(o)(5) with her Form 1040. The interest on 3/5's of the loan are deductible as business interest expense. But, the interest on 2/5's of the loan is no longer deductible, not even as home equity debt because the §1.163-10T(o)(5) election out applies to the entire proceeds. Interest on debt used personally is not deductible at all. And the election is an all or nothing election. It would have been much smarter for her to have taken out two separate loans.

> ***Planning point.*** Failing to make an election may be to the taxpayer's advantage if the proceeds are used to buy a rental (and if the client is not in AMT). Since passive rules can often suspend any rental loss, Schedule A interest deduction may result in lower current tax.

Planning points on when to make the “10T” election.
1. Taxpayer borrows from his home equity to buy a rental property or to pay off the mortgage on a rental property. 2. Taxpayer borrows from his home equity to invest in stock or first mortgages. 3. Taxpayer borrows from his home equity to capitalize or cover a cash shortfall in his Schedule C business.

Qualified Residence Debt Limitations (§163(h)(3)(B))

In most cases, all home mortgage interest is deductible. However, whether it is all deductible depends on the date the taxpayer took out the mortgage, the amount of the mortgage, and the use of its proceeds (§163(h)(3)).

Acquisition Indebtedness Is Defined as Any Indebtedness Which Is:

1. incurred in acquiring, constructing, or substantially improving any qualified residence of the taxpayer; and
2. secured by such qualified residence (§163(h)(3)(B)(i)).

For these purposes acquisition and improvement costs include amounts paid to acquire any interest in a qualified home or to substantially improve the home. The cost of building or substantially improving a qualified home includes the costs to acquire real property and building materials, fees for architects and design plans, and required building permits. Improvements are substantial if they:

1. add to the value of the home;
2. prolong the home's useful life; or
3. adapt the home to new uses.

Repairs that maintain a home in good condition, such as repainting, are not substantial improvements. However, if a taxpayer paints the home as part of a renovation that substantially improves the qualified home, include the painting costs in the cost of the improvements.

Under §163(h)(3)(B)(ii), the aggregate amount treated as acquisition indebtedness for any period is limited to $1,000,000 ($500,000 in the case of a married taxpayer filing a separate return).

Under §1.163-1(b), interest actually paid by a taxpayer on a mortgage where the taxpayer is the legal or equitable owner of the underlying property may be deducted as interest on the taxpayer's indebtedness - even if the taxpayer is not directly liable on the bond or note secured by the mortgage.

IRS Chief Counsel Allows Interest Deduction on $1.1 Million Used to Buy Home

Purchase loan can be both acquisition and equity loan. In an amazing reversal of its long-standing position on the acquisition indebtedness limitation, IRS Chief Counsel on October 2, 2009 released CCA 200940030. The issue has been whether indebtedness that is incurred by a taxpayer to acquire, construct, or substantially improve a qualified residence can constitute "home equity indebtedness" (within the meaning of § 163(h)(3)(C)) to the extent it exceeds $1 million.

In issuing this advisory **(CCA 200940030)**, Chief Counsel's office concluded indebtedness incurred by a taxpayer to acquire, construct, or substantially improve a qualified residence can constitute home equity indebtedness to the extent it exceeds $1 million (subject to the $100,000 and fair market value limitations imposed on home equity indebtedness by §163(h)(3)(C)). Counsel arrived at this conclusion by determining that indebtedness that is incurred to acquire, construct or substantially improve a residence, thus satisfying §163(h)(3)(B)(I), but that exceeds $1,000,000, so not satisfying § 163(h)(3)(B)(ii), is not acquisition indebtedness. Therefore, home equity indebtedness, as defined in §163(h)(3)(C) includes indebtedness incurred to acquire, construct or substantially improve a qualified residence, to the extent that the indebtedness exceeds the $1million limit on acquisition indebtedness and to the extent the other requirements of §163(h)(3)(C) are satisfied.

Finally, the advisory goes on to state that the Service "recognizes that the position taken in this memorandum is inconsistent with Pau v. Commissioner, (T.C. Memo.1997-43) and Catalano v. Commissioner, (T.C. Memo. 2000-82), regarding the definition of acquisition indebtedness in § 163(h)(3)(B). However, we believe that the position in this memorandum is the better interpretation of §163(h)(3)(B) and (C)."

Subsequently, IRS issued Rev. Rul. 2010-25 supporting the above position.

IRS Says $1 Million Limit Applies per Property, Not per Taxpayer

Unmarried taxpayers jointly own property. During the 3 years covered in this ruling request **(PLR 200911007) (Rev. Rul. 2010-25)**, Taxpayer 1 (for illustration call him Curt) owned a principal residence (within the meaning of §121.) Prior to the first year, Curt purchased the property for $2,000,000 and financed the purchase with a $1,600,000 mortgage, secured by property.

In Year 2, Curt transferred the property to himself and a co-owner (call her Goldie) as joint tenants. In addition, in Year 2, Goldie was added as an additional obligator on the mortgage. The facts indicate that, following the transfer of the property in Year 2, Curt owned 60% of the property and Goldie owned 40% of the property. Curt paid 60% of all interest due on the mortgage and Goldie paid 40%. As a result, Curt paid mortgage interest on acquisition indebtedness of $960,000 (60% of $1.6 million) on his principal residence, and Goldie paid mortgage interest on acquisition indebtedness of $640,000 (40% of $1.6 million) on her principal residence.

Each taxpayer thus had acquisition indebtedness of less than $1 million on a qualified principal residence. Both taxpayers can deduct the full amount of interest paid - right? Not according the IRS!

Limit applies to residence not person. Although the ruling never addresses whether the mortgage is actually acquisition indebtedness for Goldie, it does state that under §163(h)(3)(B)(i), acquisition indebtedness is defined, in relevant part, as indebtedness incurred in acquiring a qualified residence of the taxpayer - not as indebtedness incurred in acquiring taxpayer's portion of a qualified residence.

The entire amount of indebtedness incurred in acquiring the qualified residence constituted "acquisition indebtedness" under §163(h)(3)(A)(i). In this case, the amount of indebtedness incurred in acquiring the property exceeded $1,000,000. However, under §163(h)(3)(B)(ii), the amount treated as acquisition indebtedness for purposes of the qualified residence interest deduction was limited to $1,000,000 of total, "aggregate" acquisition indebtedness. The IRS believes this was evident from the parenthetical in §163(h)(3)(B)(ii) which limits the aggregate treated as acquisition indebtedness to $500,000 for a married taxpayer filing a separate return.

The secured debt in this case exceeded the applicable debt limit for that debt (i.e., $1,000,000). Therefore, for Curt, the amount of qualified residence interest with respect to the mortgage in Year 3 was determined by multiplying the amount of interest paid by Curt (i.e., 60% of the interest due) in Year 3 by a fraction: $1 million over the amount of mortgage ($1.6 million). Using this method, each was allowed to deduct only 62.5% of the interest they respectively paid!

And Wins in Court!

In 2002, Charles Sophy and Bruce Voss purchased a home together in Beverly Hills, California. The qualified home acquisition indebtedness was $2,000,000. They also had a home equity line of credit of $300,000 on the Beverly Hills home. In addition, they owned a second home in Rancho Mirage with a mortgage of $500,000. By 2006, the cumulative $2.8 million of their mortgages had been paid down to $2,703,568. Filing as two single taxpayers, Sophy and Voss *each* deducted the interest paid on $1.1 million of their mortgages. The IRS argued that the home mortgage interest deduction on *both* returns could not exceed the interest paid on $1.1 million of acquisition and home equity debt. The excess amount was not deductible (*Charles J. Sophy v. Comm., Bruce H. Voss v. Comm.*, 138 TC No. 8, Mar. 5, 2012).

The Tax Court agreed with the IRS that the $1,000,000 acquisition indebtedness and the $100,000 home equity borrowing limitations in §163(h)(3)(B)(ii) and (C)(ii) are applied on a per residence basis. Therefore, interest deductions for Sophy and Voss were limited to the interest paid on the first $1.1 million. The Tax Court found that there was nothing in the legislative history of the §163(h)(3) indebtedness limitations that suggested that Congress had any other intention than what the Court determined from an examination of the language.

The Tax Court calculated the deductible home mortgage interest as follows:

	2006	2007
Total qualified residence acquisition debt limit	$1,100,000	$1,100,000
Total average balance of all Sophy/Voss mortgage loans	$2,703,568	$2,669,136
Limitation ratio ($1,100,000/average balance for year)	.4068697	.41211838
Interest paid by Sophy: Interest paid by Voss: Total interest paid	$ 94,698 - 52.418% $ 85,962 - 47.582% $180,660	$ 99,901 - 56.590% $ 76,635 - 43.410% $176,536
Annual effective interest rate:	6.682281%	6.613975%
Interest deducible by Sophy : Interest deductible by Voss: Total mortgage interest deductible on $1.1 mill	$38,530 - 52.418% $34,975 - 47.582% $73,505	$41,171 - 56.589% $31,583 - 43.411% $72,754

Comment. The Tax Court first applied the $1,100,000 debt limit and then divided it between the co-owners based on each co-owner's actual payment schedule [see Rev. Rul 71-268; *Powell v. Comm.*, TCM 1967-32). The interest would generally be divided based on the each owner's ownership percentage if paid out of community property funds or from another jointly owned account.

Example. On January 1, 2012, Nancy and David, an unmarried couple, purchased a $400,000 principal residence as co-owners. The interest paid by each would be fully deductible (no limit) as qualified residence acquisition debt.

Example. On March 1, 2012, Charlie and Bruce purchased a $1.6 million principal residence as co-owners using a $1.4 million interest-only jumbo mortgage. The interest paid on $300,000 (the amount in excess of the $1,100,000 debt limit) is not deductible. The interest paid on the first $1.1 million is deductible and would by divided between the two owners.

Preparer point. In other words, whether the buyers are married or unmarried, the mortgage interest deduction would be the same.

Refinanced Home Acquisition Debt Still Qualifies as Acquisition Debt

However, the new debt will qualify as home acquisition debt only up to the amount of the balance of the old mortgage principal just before the refinancing (§163(h)(3)(B)). Any additional debt is not home acquisition debt, but may qualify as home equity debt.

Example. When Steve bought his house in 2000, his acquisition mortgage was $200,000. In 2006, an auto dealer told Steve he could deduct the interest he paid on his "auto loan" if he refinanced his house and used the proceeds to buy a new car. Steve refinanced his home loan to $225,000. In 2010, Steve again refinanced his home in the amount of $350,000 to buy two new cars and take a well deserved vacation. Steve's in trouble, as his home equity borrowing now exceeds $100,000. A portion of his interest is nondeductible personal interest.

Planning Point. Borrowing from home equity to buy an auto produces deductible interest (as long as equity loans are below $100,000) but the auto loan is a 30 year loan. Steve, example above, already has three auto loans wrapped up in his refinance.

Mortgage Later Secured by Qualified Home (Notice 88-74)

Such situations include when the taxpayer:

1. buys home within ***90 days*** before or after the date he or she takes out the mortgage. The home acquisition debt is limited to the home's cost, plus the cost of any substantial improvements within the limit described below in (2) or (3);
2. builds or improves home and takes out the mortgage before the work is completed. The home acquisition debt is limited to the amount of the expenses incurred within 24 months before the date of the mortgage; or
3. builds or improves home and takes out the mortgage within 90 days after the work is completed. The home acquisition debt is limited to the amount of the expenses incurred within the period beginning 24 months before the work is completed and ending on the date of the mortgage.

Example. Norm bought his residence on June 3, 2010 for $175,000. He paid for the residence with cash. On July 15, 2010, Norm took out a mortgage of $150,000 secured by his new residence. He used the $150,000 to invest in stocks. Norm can treat the mortgage as taken out to buy his residence because he bought the home within 90 days before he took out the mortgage. The entire mortgage qualifies as home acquisition debt because it was not more than the home's cost.

Example. On January 31, 2010, Ed began building a residence on a lot that he owned. He used $145,000 of his personal funds to build the home, which was completed on October 31, 2010. On November 21, 2010, Ed took out a $120,000 mortgage secured by his new residence. The mortgage may be treated as used to build the home because it was taken out within 90 days after the home was completed. The entire mortgage qualifies as home acquisition debt because it was for less than the total construction expenses incurred within the period beginning 24 months before the home was completed.

Mortgage date is generally the day the loan proceeds are disbursed. This is generally the closing date. However, a taxpayer can treat the day he or she applied in writing for a mortgage as the date it was taken out. This applies only if the taxpayer receives the loan proceeds within a reasonable time (such as within 30 days) after the application is approved. If a timely application is rejected, a reasonable additional time will be allowed to make a new application (Notice 88-74).

Non-qualifying mortgage may later become qualifying. A mortgage that does not qualify as home acquisition debt because it does not meet all the requirements may qualify at a later time. For example, a debt used to buy a home may not qualify as home acquisition debt because it is not secured by the home. However, if the debt is later secured by the home, it may qualify as home acquisition debt after that time. Similarly, a debt that you use to buy property may not qualify because the property is not a qualified home. However, if the property later becomes a qualified home, the debt may qualify after that time.

Home Equity Debt Limit

There is a limit on the amount of debt that can be treated as home equity debt. The total home equity debt on a main residence and second residence is limited to the ***smaller*** of:

- $100,000 ($50,000 if married filing separately); or,
- the total of each home's fair market value (FMV) reduced (but not below zero) by the amount of its home acquisition debt and grandfathered debt. Determine the FMV and the outstanding home acquisition and grandfathered debt for each home on the date that the last debt was secured by the home.

Home equity interest not deductible for AMT. Only home mortgage interest used to buy, build or substantially improve the taxpayer's principal residence or second home is deductible for AMT (§56(e)). While the regular tax allows a deduction for mortgage interest expense from an equity loan up to $100,000, the AMT has no similar provision.

Acquiring an Interest in a Home Because of a Divorce

If one spouse incurs debt to acquire the interest of another spouse or former spouse in a home, because of a divorce or legal separation, the debt is home acquisition debt.

Using the Home as an ATM

Allocation of Interest - The Interest Tracing Rules. When loan proceeds are used for more than one purpose, interest is allocated in the same manner as the loan itself is allocated. This is accomplished by tracing disbursements of the debt proceeds to specific uses (§1.163-8T(a)(3)). The rules for deducting interest vary depending on what the loan proceeds are used for. If the proceeds of a loan are used for more than one type of expense, an allocation must be made to determine the interest for each use of the loan's proceeds. Interest is allocated to the following categories:

- Trade or business interest;

- Passive activity interest;
- Investment interest
- Portfolio interest
- Personal interest

Loan security does not dictate deductions. The allocation of loan proceeds and the related interest is not generally affected by the use of property that secures the loan (§1.163-8T(c)).

Example. Cindy secures a loan with equipment used in her business. She uses the loan proceeds to buy golf clubs and a membership to the local golf club. Cindy must allocate interest expense on the loan to personal use (purchase of golf clubs and membership) even though the loan is secured by business property.

Allocation period determines how interest is deducted. The period for which a loan is allocated to a particular use begins on the date the proceeds are used and ends on the earlier of the following dates:

1. the date the loan is repaid; or
2. the date the loan is reallocated to another use (§1.163-8T(c)(2)).

Example. On January 1, Karen, a calendar year taxpayer, borrows $1,000 at an interest rate of 11%, compounded semiannually. Karen immediately uses the debt proceeds to purchase an investment security. On July 1, Karen sells the investment security for $1,000 and uses the sales proceeds to make a passive activity expenditure. On December 31, Karen pays accrued interest of $113 on the $1,000 debt for the entire year.

Under §1.163-8T(c)(2), the $1,000 debt is allocated to the investment expenditure for the period from January 1 through June 30, and to the passive activity expenditure from July 1 through December 31. Interest expense accruing on the $1,000 debt is allocated in accordance with the allocation of the debt even though the debt was allocated to the passive activity expenditure on the date the interest was paid.

Thus, the $55 interest expense for the period from January 1 through June 30 is allocated to the investment expenditure. In addition, during the period from July 1 through December 31, the interest expense allocated to the investment expenditure is a debt, the proceeds of which are treated as used to make an investment expenditure. Accordingly, an additional $3 of interest expense for the period from July 1 through December 31 ($55 x .055) is allocated to the investment expenditure. The remaining $55 of interest expense for the period from July 1 through December 31 ($1,000 x .055) is allocated to the passive activity expenditure.

Alternatively, under the rule in §1-163-8T(c)(2)(ii)(B), Karen may allocate the interest expense on a straight-line basis and may also treat the year as consisting of 12 30-day months for this purpose. In that case, $56.50 of interest expense (180/360 x $113) would be allocated to the investment expenditure and the remaining $56.50 of interest expense would be allocated to the passive activity expenditure.

Even if the lender disburses the loan proceeds to a third party, the allocation of the loan is still based on the use of the funds. This applies whether the taxpayer pays for property, services, or anything else by incurring a loan, or takes property subject to a debt (§1.163-8T(c)(3)).

Loan proceeds deposited in borrower's bank account are treated as used for investment. It does not matter whether the account pays interest. Any interest paid on the loan is investment interest expense. If the taxpayer withdraws the proceeds of the loan, reallocate the loan based on the new use of the funds (§1.163-8T(c)(4).

Example. Connie, a calendar-year taxpayer, borrows $100,000 on January 4 and immediately uses the proceeds to open a checking account. No other amounts are deposited in the account during the year and no part of the loan principal is repaid during the year. On April 1, Connie uses $20,000 from the checking account for a passive activity expenditure. On September 1, Connie uses an additional $40,000 from the account for personal purposes.

Under the interest allocation rules, the entire $100,000 loan is treated as property held for investment for the period from January 4 through March 31. From April 1 through August 31, Connie must treat $20,000 of the loan as used in the passive activity and $80,000 of the loan as property held for investment. From September 1 through December 31, she must treat $40,000 of the loan as used for personal purposes, $20,000 as used in the passive activity, and $40,000 as property held for investment.

The order funds are spent in determines use, not actual tracing. Generally, loan proceeds deposited into an account are treated as spent ***before*** either of the following amounts:

- any un-borrowed amounts held in the same account; and
- any amounts deposited after the loan proceeds (Reg. §1.163-8T(c)(4)(ii)).

Under Reg. §163-8T, it is not necessary that the actual loan proceeds be directly spent for business purposes. If proceeds from debt are deposited into an account and combined with other amounts, any expenditures from the account are treated as first coming from the debt, and then from other sources. However, taxpayers are allowed to treat amounts spent within 15 days of the incurrence of the debt to be deemed spent on business expenses.

Debt Repayment Ordering Rules Make a Big Difference in Deductions

If a debt is used for more than one purpose (i.e., business, investment, personal), then ordering rules come into play when calculating how to apply principal payments to the debt (§163-8T(d)(1)). The ordering rules require that when debt is repaid, principal payments are allocated in the following order:

1. Personal expenditures
2. Investment expenditures and non-rental real estate passive activities
3. Rental real estate passive activities in which the taxpayer actively participates
4. Former passive activities
5. Trade or business activities.

Example. On January 1, 2009, Sean borrows $100,000 from his unsecured line of credit and uses $50,000 to pay bills for his Schedule C business, $30,000 as a down payment for the purchase of a rental residence and the remaining $20,000 is used for personal purposes. In 2009, Sean makes one loan payment on December 31, 2009 in the amount of $20,000 ($10,000 interest and $10,000 principal). Accordingly, the interest allocation for 2009 is $5,000 (50%) to Schedule C, $3,000 (30%) to Schedule E and $2,000 (20%) non-deductible personal interest.

On December 31, 2010, Sean makes another $20,000 payment ($9,000 interest and $11,000 principal). Based on the rules discussed above, the 2010 interest allocation percentages are much different. Sean will deduct interest of $4,999 (55.6%) on Schedule C, $3,000 (33.3%) on Schedule E, and $1,001 (11.1%) non-deductible. In addition, the entire $10,000 principal payment will be allocated to the personal portion of the loan, resulting in no interest allocation to personal debt in 2011 and thereafter.

Planning Point*.* The only exception to the direct tracing rules is when the taxpayer uses a personal residence to secure a business loan. In this case the interest expense is deductible as residence interest on Schedule A. On the surface, why care? You still get the deduction. But this treatment cleverly results in increasing the taxpayer's Schedule C income by that interest amount, which, in turn, is subject to a 15.3% self-employment income tax.

Tax relief only for the aware. At the taxpayer's election, a home equity loan can be traced to business use rather than be qualified residence interest (by attaching a §1.163-10T(o)(5) election to the return).

Late Payment Charge on Mortgage Payment

Generally, late payment charges on mortgages are deductible as mortgage interest expense as long as the underlying mortgage is a qualifying mortgage (IRS Pub. 936). However, if the late payment charge is for a specific service provided by the lender in connection with servicing the mortgage loan, it is not deductible (*Robert G. West v. Comr.,* TC Memo 1991-61).

Mortgage Prepayment Penalty
If the taxpayer pays off a home mortgage early, he or she may have to pay a penalty. Such penalties are deductible as home mortgage interest provided the penalty is not for a specific service performed or cost incurred in connection with the mortgage loan (Rev. Rul. 57-198).

Mortgage Interest Credit (§25)
Certain taxpayers qualify to claim a credit against income tax based on the amount of mortgage interest paid. Qualifying taxpayers must be issued a Mortgage Credit Certificate (MCC) by a state or local government under a qualified mortgage credit certificate program. The home to which the certificate relates must be the taxpayer's primary residence and must be located in the jurisdiction of the governmental agency that issued the certificate. The rate of the credit varies between 10 and 50%; however, if the rate is greater than 20%, the credit for the year is limited to $2,000. The credit may not be claimed for mortgage interest paid to a related party. If this credit is taken, the taxpayer must reduce the mortgage interest deduction by the amount of the credit (§1.163-6T).

Ministers' and Military Housing Allowance
A minister is frequently provided a parsonage or is paid a housing allowance, which is exempt from income tax under §107. The parsonage allowance is subject to self-employment tax. Ministers (or members of the uniformed services) who receive a tax free housing allowance may still deduct home mortgage interest.

> ***Planning Point.*** Because of the exemption from income tax for the "allowable" parsonage or housing allowance, the operation of §265 requires business expenses to be allocated between taxable and non taxable income.

For more information on the parsonage allowance, see Audit Technique Guide for Ministers released 6-30-09.

Mortgage Assistance Payments
If a taxpayer qualifies for mortgage assistance payments under §235 of the National Housing Act, part or all of the interest on his or her mortgage may be paid on his or her behalf. Do not deduct the interest that is paid for the taxpayer. Do not include these mortgage assistance payments in income, either. Also, do not use these payments to reduce other deductions, such as real estate taxes.

Divorced or Separated Individuals
If a divorce or separation agreement requires that the taxpayer pay home mortgage interest on a home owned by both the taxpayer and the former spouse, the payment of the mortgage is likely ***alimony,*** assuming all of the alimony requirements are met. In such circumstances, the payor receives an interest deduction for half of the payment made and an alimony deduction for the other half of the payment. The payee spouse has alimony

income for half of the payment made, but is allowed a deduction for half of the mortgage interest paid for the year (Rev. Rul. 67-420).

Mortgage Proceeds Invested in Tax-Exempt Securities
Do not deduct the home mortgage interest on grandfathered debt or home equity debt if the proceeds of the mortgage were used to buy securities or certificates that produce tax-free income.

Refunds of Interest
If the taxpayer receives a refund of interest in the same year paid, reduce interest expense by the amount refunded. If the taxpayer receives a refund of interest deducted in an earlier year, generally include the refund in income in the year received. However, the tax benefit rules apply here, so include it only up to the amount of the deduction that reduced tax in the earlier year. This is true whether the interest overcharge was refunded or was used to reduce the outstanding principal on the mortgage. Report any refund included in income on line 21, Form 1040. If a refund of interest overpaid in an earlier year was received, the taxpayer generally will receive a Form 1098, *Mortgage Interest Statement*, showing the refund in box 3.

Below Market Loan
Special rules apply to loans that do not have an interest rate approved by the government. Family loans may fall subject to this rule that accrues interest as if it were received by the lender and paid by the borrower.

A below market loan is a loan on which no interest is charged or on which interest is charged at a rate below the applicable federal rate. §7872 characterizes a below-market loan as two transactions.

1. The lender is treated as making a loan to the borrower, requiring the payment of interest at the applicable Federal rate.

2. There is an imputed transfer of funds from the lender to the borrower in an amount sufficient to fund the payment of the interest by the borrower. The imputed transfer from the lender to the borrower is characterized in accordance with the substance of the transaction (e.g., as a gift, compensation, dividend, etc.)

Example. Holly borrows $100,000 from her mother to make the down payment on her new home. Mom doesn't charge interest. If the applicable federal rate at the time of the loan is 4.4%, Holly is considered to have paid $4,400 of interest expense and Mom is considered to have received $4,400 of interest income. Mom will pay tax on her income but Holly will only get a mortgage interest deduction if she has properly secured the loan against her personal residence.

Limit on forgone interest for gift loans of $100,000 or less. For gift loans between individuals, forgone interest treated as transferred back to the lender is limited to the borrower's net investment income for the year. This limit applies if the outstanding loans between the lender and borrower total $100,000 or less. If the borrower's net investment income is $1,000 or less, it is treated as zero. This limit does not apply to a loan if the avoidance of any federal tax is one of the main purposes of the interest arrangement.

Example continued. If Holly has little or no interest income of her own, neither she nor Mom will accrue interest on the gift loan since it does not exceed the $100,000 limit.

Sale of Principal Residence

The $250,000/$500,000 MFJ Rule

Up to $250,000 of gain ($500,000 for married filing jointly [MFJ]) realized on the sale or exchange of a principal residence on or after May 7, 1997, is not ***taxable*** (not just deferred) 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 (§121). But, this provision is denied to disqualified expatriates (§121(e); §877(a)(1)).

The §121 Qualification Requirements

To qualify for this tax break:

1. "Own for two years" rule: the taxpayer, with three notable exceptions discussed later, must own the home as his or her principal residence for a total of two years during the five-year period ending on the date of the sale or exchange (§121(a)),

2. "Occupy for two years" rule: the taxpayer, with the same three exceptions, must use the home as his or her principal residence for a total of two years during the five-year period ending on the date of the sale or exchange (§121(a)), and

3."No more than once every two years" rule: the taxpayer cannot report, during the 2-year period ending on the date of sale, other post-May 6, 1997 sales or exchanges to which §121 applies (§121(b)(3)).

50% Owner Gets 100% Exclusion on Sale of Home

Sung Huey Mei Hsu sold her 50% interest in a home in 2005. Ms. Hsu realized a $264,000 gain from the sale and, because she met all the §121 requirements, excluded $250,000 of the gain from her taxable income. The IRS, ignoring its own regulations, only allowed her to exclude $125,000, arguing that her exclusion should be prorated by her ownership percentage. The court, however, noted that such prorations are not required under §121 and brought to the IRS's attention that the Regulations specifically provide that joint owners of a property are allowed up to exclude up to $250,000 if that is attributable to each taxpayer's interest in the property (§1.121-2(a)(2)) (***Sung Huey Mie Hsu v. Comm.***, TCS 2010-68).

Court Rules Replacement Home Must Be Occupied to Qualify for §121 Exclusion

David Gates purchased an 880-square-foot home in 1984 for $150,000. In 1989, David married Christine Gates and the couple resided in the David's home for two years from August 1996 to August 1998. In 1996 the Gates decided to enlarge and remodel the original house. However, their architect advised them that more stringent building and permit restrictions had been enacted since the original house was built and remodeling would be cost prohibitive. The Gates decided to demolish the original house and construct a new three-bedroom house in its place.

Now the problem. For a variety of reasons, David and Christine never resided in the new house and put it up for sale. On April 7, 2000, they sold the new house and land for $1,100,000 and realized a gain of $591,406. The Gates agreed that $91,406 of the gain should have been included in their gross income for 2000, but they asserted that the remaining gain of $500,000 was excludable under §121. The Gates position was that the time they occupied the old home tacks onto the new home. The IRS, on the other hand, argued that the new home was never occupied and, therefore, the requirement under §121 to live in the home for two years was not met.

Court looks to legislative history to help make decision. In order to make its decision, the court determined the terms "property" and "principal residence" must be defined. It looked at legislative history and concluded that the terms refer to "a house or other dwelling unit in which the taxpayer actually resided." Because the Gates never occupied the home, they were not eligible to exclude the gain.

Dissenting opinion. Judge Halpern wrote a spirited dissent on this case and was supported by four other tax court judges. He noted that the §121 exclusion was intended to be a remedy by providing a simpler method for excluding gain than the rollover method provided by §1034. He also noted the potential inequity where a taxpayer whose longtime home is demolished by a natural disaster (e.g., hurricane) and not covered by insurance. If the taxpayer rebuilt on the same land and lived in the rebuilt house for 18 months, when the house and land are sold at a gain, under this decision by the majority, the exclusion would not apply because the "live there for two or more of the last 5 years" test would not be satisfied. If, however, the house had only been damaged, and was repaired, the exclusion would apply. In a candid summary, Judge Halpern noted that he would have treated the demolition and reconstruction of the home no differently than a renovation. As a second best solution, he would have treated the demolished home as being sold for zero dollars and apply §121 to the subsequent sale of the land (and the new house) (***David and Christine Gates v. Comm.,*** 135 TC No. 1, 19350-05, July 1, 2010).

California Taxpayer Not Entitled to Gain Exclusion

Jesus Padilla sold a home in California in 2004. Although California withholding was taken at 3.33% of the gross proceeds at the time of sale, Jesus did not file a California tax return for 2004. When FTB issued a Notice of Proposed Assessment (NPA) for the year, Jesus claimed he was a full year resident of Arizona, and owed no California tax for 2004.

When informed by FTB that even nonresidents owe tax on the sale of real property located in California, Jesus changed his story on appeal and declared that he still didn't owe any tax because the gain on the sale was subject to exclusion because it was his principal residence. Jesus provided no documentation at his appeal hearing to demonstrate that the property had ever been his residence, let alone for two out of the last five years before sale. Absent substantiating documents such as a California driver's license, voter record, or utility bills listing his residential address, Jesus lost his claim for IRC §121 exclusion (*Appeal of Padilla*, SBE 2011, Case No. 485852).

The $250,000 Exclusion Doubles to $500,000 MFJ If Four Requirements Are Met

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

Surviving Spouses Entitled to $500,000 Exclusion

The $500,000 maximum exclusion of gain from sales or exchanges of principal residences that applies to joint return filers also applies to qualifying sales or exchanges by surviving spouses after December 31, 2007 (§121(b)(4)). The increased exclusion amount applies to a sale or exchange of property by an unmarried individual whose spouse is deceased on the date of such sale if:

1. the sale occurs no later than two years after the date of death of such spouse, and

2. immediately before the date of death, either spouse met the two-out-of-five year ownership requirement, both spouses met the two-out-of-five year use requirement, and neither spouse was ineligible to claim the exclusion because of another sale or exchange within the prior two years that qualified for the exclusion (§121(b)(4).

Thus, for the ownership and use requirements, only one spouse must have owned the property for periods aggregating two years or more during the five-year period immediately before the date of death. However, both spouses must have met the use requirement by using the property as a principal residence for periods aggregating two years or more during the five-year period immediately before the date of death (§121(b)(2)(A)(i) and (ii)).

Community property. This provision is likely to have little tax impact on the surviving spouse when the personal residence is owned as community property. Since the basis of both halves of the property steps up to fair market value at the first spouse's death, the surviving spouse that sells the personal residence within a few years often has little gain to report from the sale.

Example. Jane and John owned their personal residence as community property. Jane and John otherwise qualify for the §121 exclusion. At John's death December 2007, the basis in their house was $100,000 and its FMV was $600,000. Jane sells the house November 2009 for $700,000. Her gain at sale is $100,000 ($700,000 less $600,000, the FMV at her spouse's death.) Under the prior law, Jane would not have paid tax on the gain since it is less than her individual $250,000 gain exclusion. Under the new law, she doesn't pay either since her gain is less than the $500,000 gain exclusion.

Joint tenancy property. In many cases, this provision will provide tax relief to a surviving spouse when the couple owns the property as joint tenants. The basis in only ½ (the inherited half) of joint tenant property steps up to fair market value at the first spouse's death. The surviving spouse may now exclude $500,000 of gain.

Example. Jane and John owned their personal residence as joint tenants. Jane and John otherwise qualify for the §121 exclusion. At John's death December 2007, the basis in their house was $100,000 and its FMV was $600,000. Jane sells the house November 2009 for $700,000. Her gain at sale is $350,000 [$700,000 less $350,000 basis calculated at ½ of their basis ($50,000) and ½ of FMV at date of spouse's death ($300,000).] Under the prior law, Jane would have paid tax on a gain of $100,000 ($350,000 less her $250,000 gain exclusion). Under the new law, she may exclude the entire gain (up to $500,000.)

Separate property of the surviving spouse. This new provision will provide the biggest tax relief to the surviving spouse that owned the house as her separate property since she is likely to have the biggest gain at sale. Since she did not inherit the property in part or in whole from the deceased spouse, she receives no step up in basis at her spouse's death. If she sells the home within two years of the spouse's death, she'll be entitled to exclude $500,000 of gain (rather than the $250,000 under prior law.)

Example. Jane and John are married but the personal residence is Jane's separate property. Jane and John otherwise qualify for the §121 exclusion. At John's death December 2007, Jane's basis in her house was $100,000. Jane sells the house November 2009 for $700,000. Her gain at sale is $600,000 ($700,000 less $100,000.) Under the prior law, Jane would have paid tax on $350,000 ($600,000 less her $250,000 gain exclusion). Under the new law, Jane will pay tax on $100,000 ($600,000 less a $500,000 gain exclusion.)

Spouse remarries within two years. The new provision only applies to an unmarried person. If the surviving spouse remarries and sells the house within two years of the first spouse's death, she is not entitled to use this special provision and is likely to qualify for only her $250,000 exclusion.

Effective date. The provision applies to sales or exchanges after December 31, 2007.

Exclusion of Gain Does Not Apply to Nonqualified Use

For sales and exchanges after December 31, 2008, gain from the sale or exchange of a principal residence allocated to periods of nonqualified use is not excluded from gross income.

Computation. The amount of gain allocated to periods of nonqualified use is the amount of gain multiplied by a fraction the numerator of which is the aggregate periods of nonqualified use during the period the property was owned by the taxpayer and the denominator of which is the period the taxpayer owned the property.

Nonqualified use. A period of nonqualified use means any period (not including any period before January 1, 2009) during which the property is not used by the taxpayer or the taxpayer's spouse or former spouse as a principal residence. For purposes of determining periods of nonqualified use, (i) any period after the last date the property is used as the principal residence of the taxpayer or spouse (regardless of use during that period), and (ii) any period (not to exceed two years) that the taxpayer is temporarily absent by reason of a change in place of employment, health, or, to the extent provided in regulations, unforeseen circumstances, are not taken into account.

Post-May 6, 1997 depreciation. If any gain is attributable to post-May 6, 1997, depreciation, the exclusion does not apply to that amount of gain, as under present law, and that gain is not taken into account in determining the amount of gain allocated to nonqualified use.

Example 1. Assume that Sharon buys a property on January 1, 2009, for $400,000, and uses it as rental property for two years claiming $20,000 of depreciation deductions. On January 1, 2011, Sharon converts the property to her principal residence. On January 1, 2013, she moves out, and sells the property for $700,000 on January 1, 2014. As under present law, $20,000 gain attributable to the depreciation deductions is included in income. Of the remaining $300,000 gain, 40% of the gain (2 years divided by 5 years), or $120,000, is allocated to nonqualified use and is not eligible for the exclusion. Since the remaining gain of $180,000 is less than the maximum gain of $250,000 that may be excluded, gain of $180,000 is excluded from Sharon's gross income.

Example 2. Assume that Vern buys a principal residence on January 1, 2009, for $400,000, moves out on January 1, 2019, and on December 1, 2021 sells the property for $600,000. The entire $200,000 gain is excluded from gross income, as under present law, because periods after the last qualified use do not constitute nonqualified use.

Note. This exception to nonqualified use allows Vern to rent the house while he waits for a better market or while he decides if his retirement move to Arizona is the right move.

Example 3. Assume that Ron bought a vacation home on July 1, 2005 for $100,000. He converts the vacation home to his personal residence on January 1, 2011 and sells it January 1, 2014 for $300,000. Since Ron has nonqualified use (after December 31, 2008) of 2 years of the 8 ½ years that he owned it, only 6 ½ / 8 ½ of the $200,000 gain on the sale of the home is excludable under §121.

Example 4. Assume that Karen bought a rental property in 2001 for $400,000. Karen converted the rental house to her personal residence on December 1, 2008. She sells the home on April 16, 2011 for $650,000. Karen's gain is entirely excludable (except for depreciation claimed during the rental period) as she has no nonqualified use after December 31, 2008.

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

Three exceptions permit the homeowner still to exclude some (or all?) of the gain: If the primary reason the homeowner cannot comply with any (or all) of the two-year rules is because of:

1. change in place of employment,
2. health, or
3. other unforeseen circumstances, as provided in IRS regulations,

. . .the taxpayer will still be able to exclude a portion of the $250,000/$500,000 MFJ exclusion multiplied by a fraction, the numerator being the shorter of (1) the use period or (2) the period between the two sales dates, and the denominator being two years (730 days). Therefore, taxpayers who have owned or used a principal residence for less than two of the five years preceding the sale or exchange or who have excluded gain from another sale or exchange during the past two years may exclude from gain a reduced maximum amount if the sale or exchange is by reason of a change in place of employment, health, or unforeseen circumstances [§121(c)(2);§1.121-3(a) & (g); TR §1.121-3(b)].

The formula to determine the "reduced exclusion" is:

____________	÷	____________	×	____________	=	____________
Own or use days **or** between-sales days		730 days (2 years)		$250,000 or $500,000 MFJ		Maximum excludable gain

Facts and circumstances or various "safe harbors" available. Taxpayers may establish by the facts and circumstances of their situations that their home sales were for one of the previously mentioned three reasons. In this situation, the taxpayer would deduct the reduced maximum exclusion against the total gain but must be ready to defend his or her position in case of an IRS audit and, if wrong, will be forced to pay back taxes, interest, and penalty. To make things easier for the taxpayer, the IRS has identified various "safe harbors" that will automatically establish that the primary reason for the sale is deemed to be a change in place of employment, health problems, or unforeseen circumstances, thereby eliminating the requirement that the homeowner defend his or her position based on facts and circumstances.

> ***Planning Point:*** The advantage to the homeowner of using any safe harbor position is that the IRS agent cannot argue against a safe harbor in an audit.

Sale or Exchange by Reason of Unforeseen Circumstances

The "primary reason" must be unanticipated. A sale or exchange is by reason of "unforeseen circumstances" if the primary reason for the sale or exchange is the occurrence of an event that the taxpayer did not anticipate before purchasing and occupying the residence [§1.121-3(e)(1)].

Definition of "qualified individual." Sales proceeds or insurance awards are eligible for the reduced maximum exclusion rule if a principal residence is required to be sold because one of the four following individuals:

1. the taxpayer,
2. the taxpayer's spouse,
3. a co-owner of the residence, or
4. a person whose principal place of abode is in the same household as the taxpayer [§1.121-3(f)]

. . .experiences an unforeseen circumstance that the homeowner did not anticipate before purchasing and occupying the residence, such as those listed below.

Facts and circumstances. A taxpayer who does not qualify for one of the above safe harbors may still demonstrate that the primary reason for the sale or exchange is unforeseen circumstances, under a facts and circumstances test, but only if the primary reason for the sale is unforeseen circumstances (§1.121-3(b)). Factors that may be relevant to the IRS in determining the taxpayer's primary reason for the sale include (but are not limited to) the extent to which:

1. the sale and the circumstances giving rise to the sale are proximate in time;
2. the suitability of the property as the taxpayer's principal residence materially changes;
3. the taxpayer's financial ability to maintain the property is materially impaired;
4. the taxpayer uses the property as the taxpayer's residence during the period of ownership of the property;
5. the circumstances giving rise to the sale 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 occur during the period of the taxpayer's ownership and use of the property as the taxpayer's principal residence.

Chart: Excuses to Use Unforeseen Circumstances Exception

Circumstances When Partial Exclusion IS Available	**Citation**
Involuntary conversion of residence, e.g., condemnation, theft	§1.121-3(e)(2)(I)
Natural or made-made disaster resulting in a casualty to residence, e.g., an earthquake, hurricane or fire	§1.121-3(e)(2)(ii) §1.121-3(e)(4) Exp1
Acts of war or terrorism resulting in a casualty to residence	§1.121-3(e)(2)(ii) Notice 2002-60
Death of taxpayer/owner	§1.121-3(e)(2)(iii)(A)
Cessation of employment eligible for unemployment compensation	§1.121-3(e)(2)(iii)(B)
Change in employment resulting in inability to pay housing/living costs; e.g., Pilot being furloughed for 6 months	§1.121-3(e)(2)(iii)(C) §1.121-3(e)(4) Exp 2
Divorce or legal separation under decree of divorce or separate maintenance	§1.121-3(e)(2)(iii)(D)
Meeting and marrying new spouse after buying home (combined family had 5 children)	LTR 200725018
Engagement breakup where both parties bought home and one cannot afford to make payments alone	§1.121-3(e)(4) Exp 6 LTR 200652041
Multiple births resulting from the same pregnancy; house too small; house became too small after birth of additional child; house became too small as adoption agencies "home study" demanded separate bedroom for adopted child	§1.121-3(e)(2)(iii)(E) §1.121-3(e)(4) Exp 3 LTR 200601022 LTR 200613009 LTR 200652041
Unforeseeable increase in other housing costs (i.e., homeowners association dues) resulting in inability to pay housing costs	§1.121-3(e)(4) Exp 4
Police officer living in condo not allowing pets is transferred to K-9 unit	§1.121-3(e)(4) Exp 9

Neighbors protest against member of household, e.g., sex predator	LTR 200403049
Circumstances When Partial Exclusion IS Available	**Citation**
Daughter moves back with retired parents living in community with age restrictions	LTR 200601023
Moved after assailant kidnapped homeowner and forced, with gun to the head, the homeowner to withdraw money from numerous ATMs.	LTR 200630004
Death threats after undercover police officer publicly identified	LTR 200615011
Undisclosed airport noise disturbing to homeowner (§1.121-3(e)(4) Exp 5 distinguished)	LTR 200702032
Child of taxpayer molested	LTR 200820016
Circumstances When Partial Exclusion IS NOT Available	**Citation**
Heavy traffic on street disturbing to homeowner (but see LTR 200702032)	§1.121-3(e)(4) Exp 5
Job promotion which allows the purchase of a bigger home	§1.121-3(e)(4) Exp 7
Appreciation of current home allows the purchase of a bigger home	§1.121-3(e)(4) Exp 8
Reduction in mortgage interest rate allows the purchase of a bigger home	§1.121-3(e)(4) Exp 8
Lottery winnings allow for the purchase of a bigger home	§1.121-3(e)(4) Exp 10

Definition of a Principal Residence

As this large exclusion-of-gain rule only applies to the taxpayer's one "principal" residence, the problems defining principal residence can be placed into four major categories: (1) types of qualified properties, (2) ownership requirements, (3) occupancy requirements, and (4) residences used also for business. This definition of principal residence is the area in which most of the tax problems and IRS controversies arise.

Where is a principal residence?
The IRS does not provide a bright-line test that identifies the principal residence when the seller has several residences. Facts and circumstances determine whether the taxpayer uses the home as a *residence*, and whether it is used as the *principal* residence (Treas. Reg. §1.121-1(b)(2)).

A taxpayer's principal residence is the land and building where the taxpayer *principally domiciles.* The principal residence determination is based upon all the facts and circumstances in each case, including the good faith of the taxpayer. It may be even be located in a foreign country (IRS Rev. Rul. 54-611). As there is no requirement that a principal residence be owned, a motel room or rental apartment may be a principal residence (IRS Rev. Rul. 60-189; IRS Rev. Rul. 73-529; ***Marvin Ziporyn v. Comm.***, TC Memo 1997-151).

A personal residence may be a single-family house, condominium, cooperative, mobile home, boat, houseboat, house trailer, or motorhome. But property used by the taxpayer as the taxpayer's residence does not include personal property that is not a fixture under local law (e.g., gain on the sale of household furniture) (Treas. Reg. §1.121-1(b)(1)).

Taxpayers who own multiple homes.
One taxpayer cannot own two principal residences simultaneously because principal is defined as "the most important" (*McDowell v. Comm.*, 40 TCM 301 (1980)). In the case of a taxpayer using more than one property as a residence, if a taxpayer alternates between two properties, the property that the taxpayer uses a majority of the time during the year will ordinarily be considered the taxpayer's principal residence (Treas. Reg. §1.121-1(b)(2)).

Example. David owns two residences, one in New York and one in Florida. From 1999 through 2004, he lived in the New York residence for seven months and the Florida residence for five months of each year. In the absence of facts and circumstances indicating otherwise, the New York residence is David's principal residence. He would be eligible for the §121 exclusion of gain from the sale or exchange of the New York residence, but not the Florida residence (Treas. Reg. §1.121-1(b)(4), Ex. 1).

In addition to the taxpayer's use of the property, relevant factors in determining a taxpayer's principal residence include, but are not limited to:

- The taxpayer's place of employment;
- The principal place of abode of the taxpayer's family members;
- The address listed on the taxpayer's federal and state tax returns, driver's license, automobile registration, and voter registration card;
- The taxpayer's mailing address for bills and correspondence;
- The location of the taxpayer's banks; and
- The location of religious organizations and recreational clubs with which the taxpayer is affiliated (Treas. Reg. §1.121-1(b)(2)(i) - (iv); also see Rev. Rul. 71-247).

Vacant Land

Gain on the sale of land considered part of a personal residence can be excluded, but no exclusion is allowed on the gain on land considered investment property held for appreciation, or business property held for profit.

A sale of vacant land that does not include a dwelling unit does not qualify as a sale of a taxpayer's residence (Treas. Reg. §1.121-1(b)(3); Rev. Rul. 56-240; Rev. Rul. 83-50; *O'Barr v. Commissioner*, 44 T.C. 501 (1965); *Roy v. Commissioner*, T.C. Memo. 1995-23; *Hale v. Commissioner*, T.C. Memo. 1982-527).

The sale or exchange of vacant land that the taxpayer has owned and used as part of the taxpayer's principal residence is eligible for the §121 exclusion if:

- **The land is adjacent to the home:** the vacant land is adjacent to land containing the principal residence;
- **Two year ownership and use:** the vacant land was owned and used as part of the taxpayer's principal residence;
- **Sale of land within two years of sale of home:** the sale or exchange of the dwelling unit occurs within two years before or after the sale or exchange of the vacant land; and
- The sale or exchange of the vacant land satisfies all other §121 requirements.

(Treas. Reg. §1.121-1(b)(3)(i))

If the above requirements are met, the sale of vacant land and the sale of the principal residence are treated as one sale eligible for the §121 exclusion (Treas. Reg. §1.121-1(b)(3)(i)(A – D); also see *Bogley v. Commissioner*, 263 F.2d 746 (4th Cir. 1959); Rev. Rul. 76-541). As a result, the maximum limitation amount of $250,000 ($500,000 MFJ) applies to the combined sales or exchanges of the vacant land and the dwelling unit (Treas. Reg. §1.121-1(b)(3)(ii)(A)).

Example. January 1, 1999 Chad bought a house and one acre of land that he uses as his principal residence. January 1, 2000 he bought 29 acres adjacent to his house and uses the vacant land as part of his principal residence. February 1, 2005 Chad sold the house and one acre and the 29 acres in two separate transactions. He sold the house and one acre at a loss of $25,000, and realized $270,000 of gain from the sale of the 29 acres. Chad may exclude the $245,000 gain from the two sales.

> ***Note!*** Judicial factors used to determine whether the surrounding land is used for a residential purpose include enjoying unobstructed views of the countryside, living in open spaces, appreciating nature, hiking, and enjoying horseback riding.

If the sales or exchanges of the vacant land and the dwelling unit occur in different tax years, the gain from the sale or exchange of the dwelling unit, up to the maximum limitation amount, is excluded first. If the gain is excluded from a joint return, each spouse is treated as excluding one-half of the gain.

If a return for a taxable year in which there was a sale or exchange of vacant land is filed prior to the sale or exchange of the dwelling unit, gain from the sale or exchange of the vacant land must be included in income in the taxable year in which the sale or exchange occurred. If the gain later qualifies for the exclusion as part of the principal residence because of the later sale of the dwelling unit, however, the taxpayer may claim the exclusion if within the period of limitation for filing a claim for a credit or refund by filing an amended return. (Treas. Reg. §1.121-1(b)(3)(ii)(C)).

Example: In 1991, Theresa buys property consisting of a house and ten acres that she uses as her principal residence. In May 2005, she sold eight acres of the land and realized a gain of $110,000. She did not sell the dwelling unit before the due date for her 2005 return and therefore is not eligible to exclude the $110,000 of gain. In March 2007, she sells the house and remaining two acres, realizing a gain of $180,000 from the sale of the house. Theresa may exclude the $180,000 of gain.

Additionally, because the sale of the eight acres occurred within two years of the date of the sale of the dwelling unit, the sale of the eight acres is also treated as a sale of Theresa's principal residence. Theresa may file an amended return for 2005 to claim an exclusion of $70,000 ($250,000 maximum exclusion less the $180,000 of gain excluded from the sale of the dwelling unit) of the $110,000 gain from the sale of the eight acres. (Treas. Reg. §1.121-1(b)(4), Ex.3).

How Much Acreage Can Be Considered as Part of the Residence When Calculating the §121 Gain Exclusion?

Example. Farmer McDonald, in contemplating a move to Florida, decides to sell his farm. He receives $1,200,000 for the house, farm buildings, outbuildings, and 500 acres, resulting in a $500,000 MFJ gain. Can he exclude the entire $500,000 MFJ gain? We know he will try!

Answer: No. Only the gain on the personal residence and the land associated with the residence can be excluded.

	Total (500 acres)	Farm (495 acres)	Home (5 acres)
Sales Price	$1,200,000	$1,000,000	$200,000
Adjusted Basis	700,000	- 650,000	- 50,000
Total Gain	$ 500,000	$ 350,000	$150,000
		(Taxable)	(Excludable)

Note: This is an appraiser's relief act! With up to $500,000 MFJ of gain at stake, valuation of multi-use property such as farm property will become one of the largest tax litigation areas in the near future!

It is a "facts and circumstances" test. An allocation has to be made when "property is used by the taxpayer as his principal residence and part is used for other (investment or business) purposes" (§1.121-1(b)(3)(i)(A - D)).

So how many acres? Prior IRS rulings and court cases have consistently allowed five to ten acres as part of the residence (Estate of F. Russell Campbell, 23 TCM (CCH) 508 (1964); Rev. Rul. 76-541, 1976-2 CB 246; Bogley v. Comm., 263 F2d 746 (4th Cir 1959)).

The "one-acre" rule! Unofficially, the IRS, in farm communities, considers one acre to be associated with the home unless the taxpayer proves that more than one acre is used for personal purposes.

The following cases outline various arguments that other taxpayers have used to prove to the court that a substantial portion of acreage should be included with the house sale.

Bennett, 8 AFTR2d 5593 (DC Ga., 1961)	All 65 acres considered part of personal residence
Richards, TCM 1993-422	28 of 158 acres considered part of personal residence
OZ Roy, TCM 1995-23	All 100 acres considered part of personal residence
Schlicher, TCM 1997-37	43 of 51 acres considered part of personal residence

Example. Bob and Janet purchased their home in 1996. Several years later, to protect their view and provide more open space, they purchased the vacant lot next door. They have landscaped the neighboring lot to be part of the usable space for their personal residence. Landscaping includes swings and a sandbox for their grandchildren and they park their RV on the back part of the lot. The facts and circumstances indicate that Bob and Janet intend the lot in be a part of their personal residence. Thus, at the sale of the house and adjoining lot, the gain on the lot would be part of the excludable §121 gain.

Planning Points for Appreciated Acreage to Be Considered Part of a Personal Residence for the §121 Gain Exclusion

Do use the property for bona fide residential purposes.
Do report mortgage interest and taxes on schedule A.
Don't use the acreage for business or agricultural use within two years of sale.
Don't claim farm or business losses on the tax return for at least two years prior to sale.
Don't show the taxpayer's occupation as farmer or rancher.
Don't claim a county property tax exemption for farming or agriculture.

Divorce and Residences

No Gain or Loss Is Recognized at the Sale or Transfer of Property Between Spouses

The basic policy of §1041 is to treat a husband and wife as one economic unit and to defer, but not eliminate, the recognition of any gain or loss on interspousal property transfers until the property is conveyed to a third party outside the economic unit. To that end, no gain or loss is recognized on the transfer of property from one spouse to another. The property takes a transferred ("carryover") basis in the hands of the recipient spouse; the carryover basis preserves the gain (or loss) until the recipient spouse transfers the property to a third party in a taxable transaction.

Example: Don and Debbie were recently divorced. Debbie owns raw land with a value of $100,000 and a basis of $10,000. Pursuant to the divorce instrument, Debbie transfers the raw land to Don for $100,000 cash. Because the transfer is incident to a divorce, Debbie does not recognize her realized gain of $90,000. However, Don's basis in the raw land is $10,000, the basis of the transferred property in the hands of the transferor (Debbie) immediately before the transfer [TR §1.1041-1T Q&A 1, 10, & 11].

A Property Settlement in a Divorce May Move the Entire Gain to Just One Spouse

Transfer of property in divorce is a tax-free gift. 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 is 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 get divorced. The divorce court awards the house (and children) 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. For example, 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!

Dividing the Ownership of the House If Gain Is in Excess of $500,000

If the gain on the sale of the marital home at the divorce will exceed $500,000, some tax will be due unless we can rethink the division of the property. Say that John and Jane are divorcing. The gain on their home is $600,000. At the sale, John can exclude a gain of $250,000 and Jane a gain of $250,000. Each will pay tax on their gain in excess of $250,000 — $50,000 each. But if one plans on remarrying in the next few years, perhaps John and Jane should reconsider the division of the home. Instead of dividing the home 50/50, the remarrying spouse, Jane, should receive, for example, 60% of the house. Jane and her new husband live in the house for two-plus years, and then the house is sold by Jane and John at a gain of $600,000. John's share of the gain ($600,000 x 40% = $240,000) is entirely excludable. Jane's share of the gain ($600,000 x 60% = $360,000) is also entirely excludable if she files a joint tax return with her new husband since she owned the house two of the past five years and she and her new husband used the house two of the past five years.

Example. Exclude $750,000 of gain. Tom and Nicole are divorcing because Nicole is in love with Brad. The gain on Tom and Nicole's personal residence is estimated at $700,000. By allocating more of the house ownership to Nicole (and less of some other marital asset), taxes can be reduced on the subsequent sale of the house. If Nicole is given 2/3 of the house in the divorce, she could exclude up to $500,000 of gain if she remarries and she and Brad occupy the house for an 2 additional years (so Brad can meet the 2 of 5 year use test.) Tom could exclude up to $250,000 of gain on his 1/3 interest when Tom and Nicole sell the house.

Example. Exclude $1,000,000 of gain. If both Tom and Nicole have new mates picked out, they could each exclude up to $500,000 of gain on the sale of the house. Each would have to live in the house with their new spouse for 2 years. Nicole and her new spouse could live in the house in 2010 and 2011. Then Tom and his new spouse could live in the house in 2012 and 2013. When the house is sold in 2014, each couple would qualify for the 2 of 5 year use test.

How Does 2 of 5 Year Rule Work If House Is Sold Several Years after Divorce?

If a husband and wife separate or divorce but do not sell their marital house for several years, one spouse may lose his/her gain exclusion and pay unnecessary tax at the subsequent sale unless care is taken. The basic rule to exclude gain on the sale of a personal residence requires that the taxpayer own and use the house two of the last five years. For example, John and Jane are separating. They agree between themselves that Jane will use the house until the youngest child graduates from high school--five years from the time John moves from the house. When the house is sold, John must pay tax on his share of the gain because he has not used the house as his personal residence two of the last five years. If John and Jane had put their agreement as to the use of the home into writing as part of a separation instrument, John could exclude gain at the sale of the home regardless of the number of years he out of the house. An exception to the "use" rules applies during any period of ownership while such individual's spouse or former spouse is granted use of the property under a divorce or separation instrument (§121(d)(3)(B)).

Planning for Changing Houses and Spouses

In tax planning for the division of property answers to several questions are important in deciding how the personal residence should be divided in the divorce.

1. What is the gain in the couple's house? If the gain is $50,000 or $100,000, it won't matter tax wise who receives the house in the divorce. However, if the gain is $400,000 or $500,000, tax may shift to the transferee spouse that could be avoided or minimized by proper planning. 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 is incident to a divorce (§1041). Thus, the property has its same basis in the hands of the transferee spouse as it did to the married couple. This rule could shift gain on the house to one spouse that could result in tax at a subsequent sale.

2. Does one of the divorcing parties have a replacement spouse in the wings? If so, a gain of up to $500,000 can be excluded (with two years of use by the new spouse) even if only one of the divorcing parties owns the house. If the gain on the house exceeds $500,000, perhaps the house ownership can be allocated to allow more gain to the remarrying spouse.

3. What other assets are there to divide? If the couple owns a house and a rental property, perhaps the rental house can be converted to a residence of one of the divorcing parties and the gain on that property qualify for exclusion with a few years of occupancy.

4. What are the children's needs? Because the children need to stay in the same school or neighborhood, it may not be possible to sell and divide the proceeds of the house sale at the time of the divorce. The decision may be: should the house be given to the custodial parent or owned jointly by both parents until some specified event. The new law makes this a less taxing decision than it was in past years. An individual will be treated as using property as a principal residence during any period of ownership while such individual's spouse or former spouse is granted use of the property under a divorce or separation instrument (§121(d)(3)(B)).

5. What choices are there for a divorcing couple? Sandra and Jesse are divorcing. While their marriage has floundered, their home has flourished and is now worth $500,000 more than they paid for it. Sandra and Jesse's tax person explains that whoever ends up with the home in the divorce may also end up with a tax problem. Generally, only $250,000 of gain from the sale of a principal residence may be excluded by a single person. What can Sandra and Jesse do to avoid tax on the sale of their home Whiteacre?

a. If both Sandra and Jesse move out of the home but maintain joint ownership after the divorce, they may each exclude $250,000 of gain if the home is sold within three years of their departure.

b. The three-year period becomes even longer if either Sandra or Jesse live in the home after the divorce. In a divorce, the use of the home by one spouse attributes to the other if spelled out in the divorce decree. Therefore, if Jesse stays and Sandra leaves, but they continue joint ownership, when the home is sold Sandra and Jesse may exclude up to $250,000 <u>each</u> as long as neither has used the exclusion provision in the two years prior to the sale of Whiteacre.

c. If the home must be transferred to one of the spouses to make the property settlement work, the ability to exclude up to $500,000 is preserved for three years if the couple remains married. A married couple filing a joint return, may exclude up to $500,000 even if only one spouse owns the property as long as both spouses used the property as their personal residence for two of the five years prior to sale. Whiteacre is transferred to Jesse as part of the property settlement. Within three years of Sandra's departure and before the divorce, Whiteacre is sold. Sandra and Jesse may exclude up to $500,000 of gain on a <u>joint return</u>. They should be cautioned about filing a joint return.

d. If it is unacceptable to maintain joint ownership or to stay married, Sandra and Jesse may still be able to exclude up to $500,000 by making the transfer of the home NOT "incident to a divorce." Gain or loss is not recognized on property transfers incident to a divorce. Thus, the out-spouse does not have a sale and the in-spouse gets no step up in basis. Conversely, if Jesse actually buys Sandra out (rather than obtaining the home "incident to a divorce"), he gets a step up in basis that eliminates half of the potential gain. Sandra may exclude up to $250,000 of the gain from the transaction.

Caution: Implementation of this strategy is tricky. Reg 1.1041-1T(b), Q&A 7 states, *"Any transfer* ***not pursuant to a divorce or separation instrument*** *and any transfer occurring* ***more than 6 years after the cessation of the marriage*** *is* ***<u>presumed</u>*** *to be* ***<u>not</u> related to the cessation of the marriage****. This presumption may be rebutted only by showing that the transfer was made to effect the division of property owned by the former spouses at the time of the cessation of the marriage."* The IRS could attempt to rebut the **<u>presumption</u>** that a transfer is not related to the cessation of marriage if the parties clearly benefitted from such treatment. The help of a divorce attorney is required.

Converting Home to Rental Use

Even though the Internal Revenue Code requires the immediate recognition of all gain on the sale or exchange of property, including the gain on the sale of a personal residence that is not excluded, any loss on the sale of personal residence is nondeductible, as it is considered a “personal, living, or family” expense.

Can a personal residence be converted to a business use prior to sale and thereby convert the nondeductible personal loss to a deductible one? Theoretically, it is possible (§165(c)(1) and (2)). But, this process is difficult.

The length of time before a personal residence becomes a rental is not known. However, the antithesis is known. If the home is rented for less than three of the last five years before sale, §121 considers it a personal residence.

One argument for the taxpayer: How a residence is being used at the date of sale is of major importance in determining whether property is business or personal [U.S. v. Winthrop, 5 Cir. 1969, 417 F.2d 905]. Therefore, the taxpayer must prove that the property is a rental when sold, and the conversion is not done for tax purposes only [William C. Horrmann, 17 TC 903 (1951)].

Basis is Lower of Cost or FMV

The adjusted basis for determining loss for property converted from personal use is the smaller of:

- The fair market value of the property at the time of conversion, or
- The adjusted basis of the property at the time of conversion.

Therefore, the loss created prior to conversion is still not deductible, either at the time of conversion or at the time of sale (§1.165-9(b)(2)).

Example. Ron bought a personal residence in Phoenix in 2007 for $500,000. The home is now worth $300,000. If he sells the home today, he will have a nondeductible loss of $200,000. Instead he decides to convert the home to rental, rent it for a period of time and then sell it when the house is a rental and deduct the loss as an ordinary §1231 loss. That doesn’t quite work. Even if the house is considered to be rental property at the sale, Ron’s basis for the sale (and for depreciation) is $300,000.

Home Office

A new nontraditional trend in the business community finds many taxpayers working out of their personal residences. When a portion of a home is used for business purposes, a percentage of the total housing costs of these normally nondeductible personal expenses may be deducted as business expenses by a taxpayer who is an individual or an S corporation.

Limitations

As Congress felt it necessary to prevent taxpayers from misusing the office-in-home deduction, it passed a general limitation that disallows *all* business deductions of the taxpayer's residence and then created narrow exceptions that require stringent "exclusive, regular and principal" rules to be followed before this deduction is permitted.

Strict Office-in-Home Rules Prevent Abuse

To deduct expenses related to the business use of part of the home, the taxpayer must meet specific requirements. Even then, the deduction may be limited. For home office expenses to qualify for a deduction, the portion of the home that is used for business must:

1. Be used *exclusively*, (however, exceptions exist)
2. On a *regular* basis,
3. In connection with a *trade or business*, AND

in ***one*** of the following ways:

4. As the *principal place of business* for any of the taxpayer's trade or business; or
5. As a place of business for meeting or dealing with patients, clients or customers in the ordinary course of business, or
6. In connection with the taxpayer's trade or business if the taxpayer is using a separate structure that is not attached to the dwelling [§280A(c)(1)].

The term ***home*** includes a house, apartment, condominium, mobile home, or boat. It also includes structures on the property, such as an unattached garage, studio, barn, or greenhouse. However, it does not include any part of the property used exclusively as a hotel or inn.

Additional Tests for Employee Use

An employee using a part of his or her home for business may qualify for a deduction for its business use. Employees must meet the tests discussed above plus:

- The business use must be for the convenience of his or her employer, and

- The employee must not rent any part of the home to his/her employer and use the rented portion to perform services as an employee for that employer.

If the use of the home office is merely appropriate and helpful, the employee cannot deduct expenses for the business use of the home.

Employee Renting Office-In-Home to Own Corporation Doesn't Work

§280A specifically disallows the deduction of any expenses incurred when an employee rents a personal residence to his/her own corporation for business purposes [*L.A. Roy,* TC Memo 1998-125; but see *William C. Cutts v. Comm.,* (TCS 2004-8), in which a shareholder rented 89% of his home to his corporation and was allowed to deduct $18,100 of rental expenses (e.g., interest, taxes, insurance and depreciation), evidently because the court determined it was a landlord-tenant case, which does not limit rental expenses, instead of an employer-employee case, which disallows rental expenses].

Therefore, a home office deduction is barred when an employee leases a portion of his or her home to the employer at fair market value. This rule also extends to an independent contractor who attempts to lease to the party for whom he or she perform services (e.g., a real estate agent should not lease office space located at home to his or her broker/owner) [§280A(c)(6)].

Why Would Any Shareholder/Employee Lease to His or Her Employer?

To save on self-employment taxes! Despite having a "naked" Schedule E, showing nothing other than the rental income, this type of arrangement can still have some positive tax benefits. First, it obviously gets some non-FICA dollars out of the company (i.e., especially where an owner/employee is involved) at a time when the FICA cap is projected to be surpassed, e.g. $110,100 in 2012. This might also lessen the amount that an owner/employee of an S corporation might otherwise have to pay in "salary" in order to avoid attack by the IRS for setting payroll at too "unreasonably low" of a level.

Self-employment tax not applied where personal property is rented in connection with real property rentals. Many owner/employees could further extend the means by which they seek to get non-FICA dollars out of their C or S corporations by leasing office equipment along with other personal property to their companies. The IRS would like to subject these personal property rentals to Schedule C treatment, and therefore, self-employment tax. Yet, given the personal property was leased in connection with a legitimate real property rental, this should not be an issue [§1.1402(a)].

Tax Tip: The downside of this strategy might be that the owner/employee would lose the immediate §179 write-off (e.g., $139,000 in 2012) because of his or her status as a "noncorporate lessor" unless certain tests were met to overcome this prohibition.

Exclusive Use Rule Exceptions

Day Care and for Storage of Inventory and Product Samples

The exclusive use requirement does not apply when the home is used for qualified *day care* of children, handicapped or the elderly, and to wholesale or retail sellers *regularly storing inventory or product samples in the home* (e.g., part-time Mary Kay or Shaklee salespeople) [§280A(c)(4); §280A(c)(2); §1.280A-2(e)].

Storing Inventory or Product Samples
When part of the home is used for the storage of inventory or product samples, the exclusive use test does not apply. However, the home worker must meet all the following five tests:

1. The inventory or product samples are kept for use in a trade or business.
2. The business is the selling of products at wholesale or retail
3. The home is the only fixed location of that trade or business.
4. The storage space is used on a regular basis.
5. The storage space is ***separately identifiable space*** suitable for storage [§280A(c)(2)].
6.

> ***Example.*** Ron's home is the sole fixed location of his business of selling mechanics' tools at retail. He regularly uses half of his basement for storage of inventory and product samples. He sometimes uses the area for personal purposes. The expenses for the storage space are deductible even though he does not use this part of his basement exclusively for business.

> ***Example.*** Barrister Bill and Dr. Bob store business records at their home. They *cannot* satisfy the storage requirements as they would fail the "selling a product" requirement and the material being stored is not "inventory or product samples."

Principal Place of Business
Prior to 1997, neither the Internal Revenue Code nor congressional committee reports explained what was meant by *principal place of business* and left it to the administrative and judicial branches to define "principal place of business," which they did, much to taxpayers chagrin in *Commissioner v. Soliman,* [113 S.Ct. 701 (1993)]; IRS Notice 93-12; and Rev. Rul. 94-24.

The Supreme Court's Definition
Essentially, the Supreme Court and the IRS draconically ruled that the principal place of business is where "client contact" occurs, as that is where the primary income-generation function is performed. This eliminated approximately 95% of the previously deducted home offices. The legislative branch corrected this inequitable result, but only effective for tax returns filed starting in 1999.

Tax Tip: This legislative correction gives small home-based businesses parity with those companies who choose to rent space and deduct the lease payments. Political pundits also claim that it recognizes advances in technology that encourage operating a home-based business, helps cut down on commuting and conserves energy, provides a financial boost to these businesses, helps create jobs and even is pro-family.

When the Taxpayer Has Only One "Regular" Business Location

If a taxpayer has only one place of business, this is considered the taxpayer's "regular" place of business, a location deemed superior to a principal place of business.

Tax Tip: If this regular place of business is in the home, the taxpayer would have a deductible office-in-home, assuming the exclusive and regular requirements are met.

> ***Example.*** Danny is a self-employed author who uses a home office to write. He spends 30 to 35 hours of his work time per week writing in his home office. Danny also spends another 10 to 15 hours of his work time per week at other locations conducting research, meeting with his publishers and attending promotional events.
>
> The essence of Danny's trade or business as an author is writing. Danny's research, meetings with publishers and attendance at promotional events, although essential, are less important and take less time than his writing. Therefore, Danny's office in the home is his principal place of business, and he can deduct expenses for the business use of the home [Rev. Rul. 94-24; IRB 1994-15,5].

When the Taxpayer Engages In Business At Multiple Locations

To reverse the *Soliman* decision, Congress created a simple, two-step test to determine if the home office is the taxpayer's principal place of business. A home office qualifies as the taxpayer's "principal place of business" if:

1. **Inside Test:** The home office is used by the taxpayer for the administrative or management activities of any trade or business of the taxpayer, and

2. **Outside Test:** There is no other fixed location of the trade or business where the taxpayer conducts substantial administrative or management activities of the trade or business [new §280A(c)(1) flush language and effective for tax years after December 31, 1998].

   Tax Tip: This liberal expansion restores the office deduction to the vast majority of the estimated 34 million business persons who work out of their home, such as:

   - home-based employees who tele-communicate to the main office;
   - doctors who perform their duties in hospitals but need to do their billings from their home offices;
   - outside salespeople who call at the customer's place of business;
   - professional speakers who prepare at home but deliver the presentation at hotels and convention centers; and
   - plumbers and other tradespeople who perform their duties at job sites away from the shop.

> ***Tax Tip:*** Many taxpayers who have a second business conducted out of their home will be able to deduct their traveling to and from their "home office" to their main office (previously considered nondeductible commuting mileage) under this expanded definition.

The Regular, Exclusive Requirements Still Valid

Of course, the home office deduction is only allowed if the office is also exclusively used on a regular basis as a place of business by the taxpayer [§280A(c)(1)].

Simplified Option for Claiming Home Office Deduction Starting with 2013 Returns

In Rev. Proc 2013-13 IRS announced a new, simplified method for the home office deduction. The new optional deduction is capped at $1,500 per year based on $5 a square foot for up to 300 square feet. Taxpayers claiming the optional deduction will complete a simplified form, rather than the Form 8829 now required.

Depreciation expense not allowed. Homeowners using the new option cannot depreciate the portion of their home used in a trade or business.

Interest and taxes claimed on schedule A. Taxpayers will claim allowable mortgage interest, real estate taxes and casualty losses on the home as itemized deductions on Schedule A. These deductions cannot not be allocated between personal and business use, as is required under the regular method.

The simplified method saves time but does it save tax dollars? In tax year 2010, nearly 3.4 million taxpayers claimed the home office deduction. IRS estimates that their new simplified method of claiming home office deduction will save taxpayers 1.6 million recordkeeping hours annually.

Example. Sharon uses a 180 square foot bedroom in her 2,200 square foot home (8%) for a home office. She otherwise qualifies for the home office deduction.

Home office expense	Simplified method @ $5 per sq ft plus Schedule A interest and taxes	Regular method @ 8% allocation
180 sq ft @ $5	$900	
$12,000 interest deduction	$960	$960
$4,000 property tax	$320	$320
$ 900 insurance		$72
$1,800 utilities		$144
$7,600 depreciation		$608
home office income tax deduction	$2,180	$2,104
home office self employment tax deduction	$900	$2,104

Planning point. During tax season, look at each 2012 home office deduction and see if this simplified method really works. It will be an easy comparison to the amount actually deducted in 2012 versus a deduction based on $5 per square foot. Seems that this “standard deduction” for the home office deduction may not work out for our clients.

Limitations regarding carryovers. The amount of the deduction computed using the safe harbor method provided cannot exceed the gross income derived from the qualified business use of the home for the taxable year reduced by the business deductions (the same as the Form 8829 method). *But*, any amount in excess of this gross income limitation is disallowed and may not be carried over and claimed as a deduction in any other taxable year.

In addition, a taxpayer who uses the safe harbor method for a taxable year may not deduct in that taxable year any disallowed amount carried over from a prior taxable year during which the taxpayer calculated and substantiated actual expenses for purposes of §280A. A taxpayer who calculated and substantiated actual expenses for purposes of §280A in a prior taxable year and whose deduction was limited by the gross income limitation in §280A(c)(5) may deduct the disallowed amount, subject to all other applicable restrictions, in the next succeeding taxable year in which the taxpayer calculates and substantiates actual expenses for purposes of §280A.

All other home office rules still apply. Current restrictions on the home office deduction, such as the requirement that a home office must be used regularly and exclusively for business and the limit tied to the income derived from the particular business, still apply under the new option.

Home Office Creates No Gain When Residence Is Sold

Exclusion of Gain Available on Portion of Home Used for Business

No allocation of gain is required if both the residential and non-residential portions of the property are within the same dwelling unit. The fact that a residence is rented or is used partially for business (i.e., a home office) at the time of sale does not disqualify the gain attributable to the business use, other than depreciation recapture, from the $250,000/$500,000 exclusion. But, the §121 exclusion will not apply to the gain allocable to any portion of property sold or exchanged with respect to which a taxpayer does not satisfy the use requirement if the nonresidential portion is separate from the dwelling unit [§1.121-1(e)(1)]. The final regulations provide that the term *dwelling unit* has the same meaning as in §280A(f)(1), but does not include appurtenant structures or other property [§1.121-1(e)(2)].

Example. Karen sells her personal residence, which contains her deductible office-in-home, for a $100,000 gain. She estimates that the office occupies 10% of her home. She can exclude the entire $100,000 gain other than the depreciation recapture of $2,000. The $10,000 gain associated with the office-in-home is not taxable [§1.121-1(e)(4), Ex. 5 & 6].

		Total		Residence		Office-in-home
Sales Price		$300,000		$270,000		$30,000
Original Cost	$200,000		$180,000		$20,000	
Less: Depreciation	(2,000)		- 0 -		(2,000)	
Adjusted basis		$198,000		$180,000		$18,000
Total gain		$102,000		$ 90,000		$12,000
§121 Exclusion		$100,000		$ 90,000		$10,000
Total taxable gain		$ 2,000		$ 0		$ 2,000

Homeowner Hint! This is a reversal of prior IRS pronouncements [see previous §1.1034-1(c)(3)(ii)] and Tax Court cases [*Poague, William W.*, DC-Va 90-2 USTC ¶50,539] which ruled if the residence was used partially for residential purposes and partially for business purposes (mixed-use property), only that part of the gain allocable to the residential portion was excludable under §121.

Tax Tip: This makes the office-in-home deduction extraordinarily attractive, i.e., a taxpayer is allowed a current tax break with no future taxable gain at time of sale! No longer does the homeowner need to convert the home office back to personal use for two-of-the-last-five years to eliminate the gain associated with the prior business use as previously permitted by Rev. Rul. 82-26.

Depreciation Recapture Still Required On Office-In-Home

§121 does not apply to the gain to the extent of any post-May 6, 1997 depreciation adjustments [§1.121-1(e)(1)]. If the depreciation for periods after May 6, 1997, attributable to the non-residential portion of the property exceeds the gain allocable to the nonresidential portion of the property, the excess will not reduce the §121 exclusion applicable to gain allocable to the residential portion of the property. The taxpayer must use the same method to allocate the basis and the amount realized between the business and residential portions of the property as the taxpayer used to allocate the basis for purposes of depreciation, if applicable [§1.121-1(e)(3)].

Can I Exclude Gain Under §121 AND Do a §1031 Exchange?

Yes you can, finally. When the IRS issued the final regulation surrounding the rules for mixed-use property in December, 2002, it allowed the business portion of a residence that is part of the same dwelling unit to be included in the $250,000/$500,000 exclusion (see above). But, IRS forgot to mention anything about the taxpayer who actually wants to exchange the business portion. The IRS released Rev. Proc. 2005-14 on January 27, 2005. The revenue procedure clarifies that a homeowner, who may exclude gain upon a sale or exchange of a home, also may benefit from a deferral of gain for a like-kind exchange with respect to the same property.

The revenue procedure indicates that, in certain cases, a homeowner may benefit from both the home-sale exclusion and the like-kind deferral. In such cases, the property must be used consecutively or concurrently as a home and a business (e.g. rental residence). The revenue procedure sets forth six examples, illustrating the treatment of depreciation and boot.

How is Office-in Home Valued if Sold for a Loss?

Comment: Normally, the IRS will deny a loss on the sale of an office-in-home on the basis that it is part of the principal residence and thus the loss is personal in nature (§165(c); §1.165-9(a)). The IRS auditor initially denied Brian and Marcie Mallin's loss but modified its position at trial, and both the IRS and the Mallin's agreed that the workshop was used for a business or income-producing purpose **(***Brian E. & Marcie L. Mallin v. Comm.*,, TCS 2008-13**)**. The crux of the remaining disagreement was how to apportion the $203,000 sale price between the residence and the workshop. Square footage, right? Wrong!

Workshop sold for a loss, but how much? During 1999 and 2000, Brian and Marcie Mallin built a 352-square-foot workshop at a total cost of $16,179, which was an addition to the existing attached two-car garage. It had a wall separating it from the garage and its own overhead garage door. At the same time, Brian began a woodworking business out of the workshop, making Adirondack chairs, tables, and ottomans. $346 of depreciation for the workshop was claimed on their 2000 Schedule C. The Mallins sold the property in February 2001 for $203,000 to a relocation company, which priced the house by averaging two appraisals, one for $200,000 and one for $206,000. Those appraisals valued the workshop as a third-car garage; one valued it at $3,000 and the other at $10,000. The Mallins separately reported the principal residence and the workshop, excluding the gain pursuant to §121 but reporting a loss of $9,731 attributed to the sale of the workshop. The Mallins adjusted basis of the workshop was $15,833 ($16,179 cost - $346 accumulated depreciation).

Appraisal, not square-footage allocation, used by court. As the workshop was approximately 9% of the home's overall square footage, the IRS argued that the $203,000 sales proceeds should be apportioned by square footage, e.g., $18,270, creating a $2,437 taxable long-term capital gain. This method was rejected by the court as it felt the workshop space was not as valuable as living space in a home. The Mallins, on the other hand, urged the court to assign $4,000 of the sale price to the workshop. They arrived at this number by calculating the difference between the 1998 appraisal of $199,000 and the 2001 sale price of $203,000; in other words, the Mallins attributed the entire increase in the home's value between 1998 and 2001 to the workshop. This method was also rejected by the court, leaving the court to create its own method of allocation, taking the average of the appraisals of the workshop value used for the 2001 sale, e.g., one valued the workshop at $3,000 and the other at $10,000. This resulted in a $6,500 deemed sales price, creating a deductible long-term capital loss of $9,333 ($6,500 - $15,833). How about that, a non-taxable gain and a deductible loss on the same property!

Comment: The court commented: “this approach may be an imperfect solution given the fact that the appraisals both value the space as a third-car garage, but, as [the IRS] recognizes, this approach mirrors the valuation of the entire South Dakota property. And, as (the Mallins} provided us with no evidence to support any other valuation, this is the best we can do on the record before us. See Rule 142(a); INDOPCO, Inc. v. Commissioner, supra; Welch v. Helvering, supra.” Under normal circumstances, an attached garage is considered part of one's home since it is clearly appurtenant to the house.

Vacation Homes

In general, a taxpayer uses a dwelling unit as a residence if he/she uses the unit (or a portion of the unit) for personal purposes during the year for more than the greater of:

1. 14 days, or
2. 10% of the number of days the unit was rented at a fair market rental (IRC §280A(d)(1)).

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

1. the taxpayer,
2. any other person who has an interest in the dwelling unit,
3. any family member of the taxpayer or other person with an interest in the unit,
4. anyone under an arrangement allowing the taxpayer to use another dwelling unit (whether or not rent is charged on the other unit), or
5. anyone paying less than fair market rent.

> ***Caution!*** Any day the dwelling is used for personal purposes counts toward personal use, even if it was rented at fair market rental that day. That day cannot be counted in number of days rented at fair market rental.

> ***Tip:*** Exceptions to the above restrictions exist for fair market rental to a family member using the dwelling as his/her principal residence, for periods of time before or after rental that the property was the taxpayer's principal residence, and for certain shared-equity financing arrangements (IRC §280A(d)).

Use of the Unit for Repairs and Maintenance

A dwelling unit is not deemed to have been used by the taxpayer for personal purposes on any day his/her principal purpose for using it is to perform repair or maintenance work on the unit. Whether the principal purpose is to perform repair or maintenance work depends on facts and circumstances including the amount of time devoted to repair and maintenance work, the frequency of the use for repair and maintenance purposes during a taxable year, and the presence and activities of companions. However, any day the taxpayer engages in repair and maintenance of the unit on a substantially full-time basis cannot be considered a day of personal use by the taxpayer (IRC §280A(d)(2)(C)).

Exception for Minimal Rental Use

If a dwelling unit is used by a taxpayer as a residence throughout the year and is actually rented for less than 15 days, the taxpayer does not need to include the rent received in income, nor may he/she deduct any expenses associated with that rental (IRC§280A(g)).

Limited Deductions

Deductions for vacation homes cannot exceed gross rent for the year. Gross rent includes both fair market rent and below-market rent received. Expenses must first be divided into personal use and rental use. Rental use deductions are calculated based on the ratio of the number of days rented at fair market rent over the total number of days the dwelling was used for any purpose.

In determining the number of rental days, include any day the dwelling was rented at fair market rent, even if the taxpayer used it that day. Do not include any day the dwelling was available for rent, but not actually rented.

> ***Caution!*** This definition of the total rental days is different for calculating deductions than the definition for determining personal use for the vacation home limitation.

That ratio is applied to all expenses of the dwelling unit, except those directly attributed to renting the property (*ie,* rental commissions and advertising) (Prop. Reg. §1.280A-3).

Ordering Deductions

Deductions (after applying the rental ratio) are allowable in the following order:

1. Deductions otherwise allowed under the Code even if not for trade or business use (*ie*, mortgage interest and property taxes).

2. Deductions allowed for rental use of a dwelling unit.

3. Depreciation and amortization.

Example. Karen owns a lakeside home which she rents at a fair rental for 90 days during the taxable year. Karen uses the home for personal purposes on 20 other days during the taxable year and also rents it to a friend at a discount for 10 days. Thus, the home is used for some purpose (other than repair or maintenance) on 120 days during the taxable year, and the rental allocation fraction may not exceed 90/120. On the basis of the following figures, Karen determines that the sum of the rental expenses for the home for the taxable year that are deductible is $2,200. The advertising expense and the Realtor®'s fee are also deductible.

Gross receipts from rental:	
90 days at $25 per day	$2,250
10 days at $15 per day	150
Total	$2,400

Computation of gross rental income:			
Gross receipts from rental		$2,400	
Less: Advertising and realtor's fee		200	
Gross rental income			$2,200
Deductions allowable under #1 above:			
	Total	*Allocable to rental*	
Mortgage interest	$1,000	$750	
Real estate taxes	800	600	
Amount allowable			1,350
Limit on further deductions			$850
Deductions allowable under #2 above:			
Insurance	$400	$300	
Utilities	600	450	
Amount allowable			750
Limit on further deductions			$100
Deductions allowable under #3 above:			
Depreciation	$1,500	$1,125	
Amount allowable			100
Net Rental Income/(Loss)			0

Tax Court Takes a More Favorable View

The tax court overrode the IRS's proposed regulation method of allocating interest and taxes in a case that was upheld in appeals. The service's method uses the same ratio for interest and taxes as for all other expenses. However, because interest and taxes are then deducted first under the ordering provisions, this method may unfairly limit the deduction for other expenses while allowing a deduction for those expenses that could be deducted elsewhere on the return (*ie*, Schedule A).

In the *Bolton* case, the court used the ratio of the ***number of rental days over the total number of days in the year*** for the allowable interest and property tax deduction. It then applied the ratio of days at fair market rent over total days used for any purpose to the remaining expenses. The result was a smaller percentage of mortgage interest and property taxes taken against rental income, the remainder of which were deductible on Schedule A. A larger amount of the other expenses attributed to the rental were then allowed before the limitation for gross rents received was met (*D.D. Bolton*, CA-9, 82-2 USTC ¶9699, aff'g TC, 77 TC 104, Dec. 38,075).

Carry forward disallowed losses from a vacation rental into the next year. The carry-forward expenses are deductible only against the same property's income in the subsequent year, regardless of whether the taxpayer had any personal use in the following year.

Sales of Vacation Homes

To the extent a vacation home is never rented, it remains a personal residence in the hands of the taxpayer. Gains on the sale of personal residences are treated as capital gains, and losses are not deductible.

Can We Exchange A Vacation Home For A Vacation Home?

The question is, at the date of exchange is the vacation home being used primarily for personal purposes or is it being held for investment purposes (e.g., for future appreciation)? An exchange of a personal-use vacation home for anything, even another vacation home, cannot use the §1031 exchange rules and therefore it would be a taxable exchange. On the other hand, a vacation home held for investment (appreciation) or as a vacation home rental would fully qualify for a like-kind exchange.

A 2007 Tax Court Decision

Facts. In 1988, Barry and Deborah Moore purchased a second home (vacation home 1) in Georgia, which the family used on weekends from mid-April to Labor Day for recreational purposes. After the Moores changed their principal residence in 1995 or 1996, the lengthened commute to vacation home 1 made its continued use impractical, and, in 1999, they agreed to purchase another vacation home (vacation home 2) closer to their principal residence. In 2000, the Moores disposed of vacation home 1 and acquired vacation home 2 pursuant to a series of transactions intended to qualify as a tax-free, like-kind exchange of those properties under §1031. Prompted by the need for liquidity incident to their then-pending divorce, the Moores were holding vacation home 2 for sale at the time of trial. The Moores and their children used both vacation homes exclusively for recreational purposes, and they never rented or offered to rent either vacation home to third parties. One of Moores' motives in acquiring and holding each vacation home was the prospect of appreciation resulting in profit on the eventual sale of each property.

According to the Court, it is a taxpayer's *primary* purpose in holding the properties that counts, not the existence of *any* investment motive, no matter how minor. The mere hope or expectation that property may be sold at a gain cannot establish an investment intent if the taxpayer uses the property as a residence. The fact that the taxpayers held the property partially because its value was expected to increase was insufficient to qualify the transactions for gain exclusion under §1031. The evidence established that the couple and their children used the property as a vacation retreat, did not rent it out or claim depreciation or investment interest expenses on it (*Barry E. Moore and Deborah E. Moore v. Comm.*, TCM 2007-134).

IRS Provides a Safe Harbor

In Rev. Proc. 2008-16 the Service announced it will not challenge whether a dwelling qualifies under §1031 as property held for productive use in a trade or business or for investment if certain qualifying use standards are met for the dwelling unit.

Qualifying Use Standards

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

1. The dwelling unit is owned by the taxpayer for at least 24 months immediately before the exchange (the "qualifying use period"); and

2. 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 for 14 days or more, and

    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.

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:

1. The dwelling unit is owned by the taxpayer for at least 24 months immediately after the exchange (the “qualifying use period”); and

2. Within the qualifying use period, in each of the two 12-month periods immediately after the exchange,

    a. The taxpayer rents the dwelling unit to another person or persons at a fair rental for 14 days or more, and

    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.

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.

***Special rule for replacement property*.** If a taxpayer files a federal income tax return and reports a transaction as an exchange under §1031, based on the expectation that a dwelling unit will meet the qualifying use standards for replacement property, and subsequently determines that the dwelling unit does not meet the qualifying use standards, the taxpayer, if necessary, should file an amended return and not report the transaction as an exchange under §1031.

Effective date. This revenue procedure is effective for exchanges of dwelling units occurring on or after March 10, 2008.

Foreclosure

Tax Issues on Foreclosure

There were 112,498 new foreclosure filings in February 2014 (a 10% decrease from January and a decrease of 27% from February 2013) the lowest level since December 2006. Florida leads the nation with the highest foreclosure rate in February 2014.

> ***Comment.*** the IRS explains the mostly negative tax ramifications upon foreclosure on its website (Pub. 4681, Q&A on Home Foreclosure & Debt Cancellation, Mortgage Debt Relief Act of 2007).

Another One of Those Quick Questions

"I lost my investment property to the bank. How much loss can I deduct?" Let's see how quick the answer is to Jack's "quick question." At the top of the housing bubble, Jack purchased for $500,000 a lot in a luxury housing development that he hoped to hold for a few years and then sell at a profit. He financed the purchase with a $450,000 mortgage from the Bank of America. After a few years of big mortgage payments and expensive property taxes, Jack tried to sell the lot. Unfortunately, prices have dropped, and the lot was worth only $300,000. He handed it back to the bank. Jack has a big tax problem, and he's not going to want to hear you tell him about it. If the mortgage is recourse (and most unimproved land mortgages are recourse), Jack has cancellation of debt income of $150,000 ($450,000 debt relief less $$300,000 FMV of lot). He has a loss on the "sale" of the property, but it doesn't help much because the loss on the sale of investment property is a capital loss, deductible at $3,000 a year for a lifetime.

It could be worse. If Jack purchased the lot with the intent someday to build his home on the lot, the loss is a nondeductible personal loss. But the COD income still applies.

It could be better. If the mortgage was nonrecourse rather than recourse, the COD income disappears. Why is that? For a nonrecourse debt, there is no COD income. The mortgage balance becomes the sales price for purposes of determining the gain or loss on the "sale." For this particular client, the Form 1099-A said that the loan was recourse, hence the big tax bill. The client swore that the debt was nonrecourse. The seller and the mortgage broker told him so. The client was able to get the Form 1099 reissued. Lucky taxpayer.

Cancellation of Debt (COD) Creates Income

A property owner's gross income, for tax purposes, includes income from discharge of indebtedness or cancellation of debt (COD)[§61(a)(12)]

Taxable as ordinary income. Cancellation of debt income is taxable as ordinary income, even if the COD arises from the sale of a personal residence or other capital gain property. COD income results when any of the borrower's debt is reduced (by compromise, negotiation, or otherwise) for less than the full amount due. COD income most commonly emanates when restructuring or settling a loan [*U.S. v. Kirby Lumber Co.*, 284 U.S. 1 (1931)].

IRS Reporting. A financial institution that forecloses on a property must file a Form 1099-A with the IRS and provide a copy to the property owner. If the financial institution discounts (reduces) the loan, it must file a Form 1099-C with the IRS and provide a copy to the borrower.

Tax Results When Borrower Loses Property by Foreclosure, Deed in Lieu of Foreclosure, or Abandonment

When a property owner surrenders property to a lender in exchange for debt forgiveness, phantom income from the transaction may be created, either as "income from the discharge of debt" or as "income from the sale of property" or as a combination of both.

Foreclosure–A Forced Surrender of Property by the Borrower to the Lender

When a borrower fails to pay a mortgage on time, the lender generally starts legal proceedings to sell the property securing that debt. This involuntary sale normally causes adverse tax ramifications to the borrower.

Debt relief causes transfer of property to be a sale–and a sale creates a gain (or loss). A foreclosure, even though the property owner has no choice, is a sale for tax purposes (it is not a gift from the borrower back to the lender!) [*G. Hammel v. Helvering*, SCt, (*rev'g* CA-6), 41-1 USTC ¶9169, 311 U.S. 504, 61, S. Ct 368].

Judicial vs. Non-Judicial Foreclosure

In many discussions about mortgage foreclosures the terms judicial and non-judicial foreclosure are used. They involve very different processes. These terms refer to how individual states handle real estate foreclosure. Under both systems, time frames and terms vary widely from state to state. The following is a brief, general description of both processes.

Judicial Foreclosures

A judicial foreclosure is a court proceeding that begins when the lender files a complaint and records a notice in the public land records announcing a claim on the property to potential buyers, creditors and other interested parties. The complaint describes the debt, the borrower's default and the amount owed. The complaint asks the court to allow the lender to foreclose its lien and take possession of the property as a remedy for non-payment.

The homeowner is served notice of the complaint, either by mail, direct service or publication of the notice. The defendant (borrower) is permitted to dispute the facts (such as show that payments were made), offer defenses or present counterclaims by answering the complaint, filing a separate suit, and/or by attending a hearing arranged by the court. If the defendant shows there are differences of material facts, a trial will be held by the court to determine if foreclosure should occur. In the vast majority of cases, however, the foreclosure action is undisputed because the borrower is in default and cannot offer facts to the contrary. If the court determines the homeowner did default and that the debt is valid, it will issue a judgment in favor of the servicer for the total amount owed, including costs for the foreclosure process. In order for the judge to determine the amount of the judgment, the servicer submits paperwork through an affidavit that itemizes the amounts due.

Next, the court will authorize a sheriff's sale. The sale is an auction of the property open to anyone and must be held in a public place. Procedures for a sheriff's sale in each locality differ, but the individual with the highest bid is granted the property. After the sale is confirmed by the court, the deed, which transfers ownership, is prepared, recorded and the highest bidder becomes the owner of the property. In most cases, the highest bidder is the servicer, who takes title of the property. The servicer then can sell the property. At this point, it is called real estate owned (REO).

Non-Judicial Foreclosures

The requirements for non-judicial foreclosure are established by state statute; there is no court intervention. When the default occurs, the homeowner is mailed a default letter and in many states a Notice of Default is recorded, at or about the same time. The homeowner may cure the debt during a prescribed period; if not, a Notice of Sale is mailed to the homeowner, posted in public places, recorded at the county's recorder's office, and published in area newspapers/legal publications. When the legally required notice period (determined by each state) has expired, a public auction is held and the highest bidder becomes the owner of the property, subject to recordation of the deed. Prior to the sale, if the borrower disagrees with the facts of the case, he or she can try to file a lawsuit to enjoin the trustee's sale.

According to RealtyTrac.com, twenty states currently use judicial procedures as the primary way to foreclose.

Judicial Foreclosure Only States	
Connecticut	Massachusetts
Delaware	Nebraska
Florida	New Jersey
Illinois	New Mexico
Indiana	New York
Kansas	North Dakota
Kentucky	Ohio
Louisiana	Pennsylvania
Maine	South Carolina
Maryland	Vermont

In some other states, a judicial foreclosure is possible as well as a non-judicial foreclosure. However, some non-judicial foreclosure states, such as California, by statute prohibit the lender from seeking a deficiency judgment against the borrower if non-judicial foreclosure is used.

Recourse Debt (Personal Liability) Versus Nonrecourse Debt (No Personal Liability)

When is a debt recourse and when is it non recourse? At foreclosure, the cancellation of debt income and the deemed sales price of the property are different, depending on whether the taxpayer is personally liable on the mortgage (i.e., a recourse mortgage) or not personally liable on the mortgage (i.e., a nonrecourse mortgage) [*J. G. Abramson*, CA-2, 42-1 USTC ¶9200, 124 F2d 416].

> ***Preparer tip:*** The lender indicates on the Form 1099-A or Form 1099-C if the defaulted mortgage is recourse or nonrecourse.

Non-Recourse Mortgage States

Each non-recourse state has its own anti-deficiency statutes that prohibit lenders from seeking judgments. In a few cases, anti-deficiency statutes do allow lenders to collect a limited amount of money from the borrower (such as the difference between the debt and the fair market value of the property).

Note that in some states (such as California) non-recourse laws apply only to “purchase money” loans (i.e. original home loans that are used to purchase property). Almost all HELOCs and home equity loans are considered recourse loans and lenders for these loans may sue borrowers to recoup loss. (Except in some cases where the second mortgage lender forces the foreclosure). There has been some speculation that mortgage refinances do not constitute “purchase money” loans. However, there have been no cases to determine this issue one way or the other.

Anti-Deficiency/Non-Recourse States	
Alaska	Minnesota
Arizona	North Carolina
California	North Dakota
Connecticut	Texas
Florida	Utah
Idaho	Washington

Nonrecourse Debt - A Foreclosure When the Borrower Is Not Personally Liable Requires Only a One-step Approach

In a nonrecourse debt, the lending institution looks only to the property for recovery of the mortgage and cannot additionally look to the borrower’s other assets. In effect, the debtor never owes more than the fair market value of the asset securing the loan! Therefore, the sales price is equal to the entire amount of the nonrecourse debt, even if the fair market value is less than the amount of the loan. The result is that there will never be COD income in the foreclosure of a property with nonrecourse debt [§1.1001-2(b); *Comm., v. John F. Tufts*, SCt, 83-1 USTC ¶9328, 461 U.S. 300 (1983)].

The gain on the surrender of secured property in exchange for the discharge of nonrecourse indebtedness is calculated as follows:

Step 1: Gain or loss from foreclosure (the one and only step). Subtract the adjusted basis from the mortgage relief. Gain from foreclosure results in income to the borrower when the mortgage forgiven exceeds the borrower's adjusted basis in the secured property [§1.1001-2(c)(7); §7701(g)].

***Example*- Nonrecourse debt:** Sharon purchased property in 2005 for $600,000 with a $550,000 adjustable rate mortgage (ARM) due and payable in five years (nonrecourse debt). The escalating interest rate on the ARM makes it impossible for Sharon to make her mortgage payments. The lending institution forecloses and the property is sold at a sheriff's sale for $500,000. Even though the property is sold by the lender for a lesser amount, Sharon has a sales price for tax purposes equal to the debt forgiveness of $550,000. Thus, Sharon has a $50,000 loss on the property sale ($550,000 sales price less $600,000 basis = $50,000 loss.) If this is Sharon's personal residence, the loss is not deductible.

Foreclosure of real property secured by NON-RECOURSE debt

Sales price - loan	$550,000
Basis	$600,000
Loss	($50,000)

Preparer Point*:* The tax reporting is the same under old law or new law. Nonrecourse loan forgiveness is treated as the sales price of the foreclosed property. Thus the Mortgage and Debt Relief Act of 2007 has no impact on Sharon's taxes.

Recourse Debt - A Foreclosure When the Borrower Is Personally Liable Requires a Two-step Calculation

Generally the deemed "sales price" when a recourse mortgage note is turned back to the lender is the actual debt relief as a result of the foreclosure. But this sales price cannot include any COD income. Therefore, a foreclosure involving a recourse debt must be bifurcated or divided into two parts: (1) income from the discharge of indebtedness and (2) gain (or loss) created by foreclosure [§1.1001-2(a)(2), and (c) (Example 8); Rev. Rul. 90-16, 1990-1 CB 12; *Bressi v. Comm.*, TC Memo 1991-651, 62 TCM 1668].

Comment: The Mortgage and Debt Relief Act of 2007 excludes COD income from the cancellation of "qualified acquisition debt" on a personal residence. Cancellation of other debt on the personal residence as well as debt on vacation homes, investment property and business property still generates taxable income.

The income on the surrender of secured property in exchange for the discharge of recourse debt is calculated as follows:

Step 1: COD income. The excess of the amount of the debt discharge over the property's fair market value, if any, is income from the discharge of indebtedness (ordinary income). This is the only amount that may be sheltered by bankruptcy and insolvency relief provisions. Of course, there is no COD income if the borrower remains liable for the deficiency [§1.1001-2(a)(2); Rev. Rul. 90-16, 1990-1 CB 12].

Step 2 : Gain or loss from foreclosure. The sales price (or fair market value when there is no sale) of property surrendered less the property's adjusted basis is the gain or loss from the disposition of property (generally capital gain or loss).

Example **- Recourse debt:** Sharon purchased a vacation home in 2005 for $600,000 with a $550,000 adjustable rate mortgage due and payable in five years. The debt is a recourse debt. When the value of the property has dropped to $500,000, Sharon stops making payments. The lending institution forecloses and the property is sold at a sheriff's sale for $500,000. The lending institution forgives the remaining amount due as it determines that "there's no blood left in the turnip." Even though Sharon receives no money and has lost her property in foreclosure, the IRS doesn't care. She has both ordinary income from COD of $50,000 and a $100,000 loss on the sale. Since this is Sharon's vacation home, the loss is non deductible.

Note: If this is rental property, the loss is a §1231 ordinary loss. If this is investment property, the loss is a capital loss, deductible at $3,000 a year.

Foreclosure of real property secured by RECOURSE debt

Mortgage	$550,000
FMV	$500,000
COD	$50,000
Sales price - FMV	$500,000
Basis	$600,000
Loss	($100,000)

Planning Point: Whether Sharon gives the property back to the lender or convinces the lender to discount the mortgage to the property's FMV, the COD income is the same.

Worksheet for Foreclosure and Repossession

Part 1. Figure ordinary income from the cancellation of debt upon foreclosure or repossession. Complete this part only if taxpayer was personally liable (recourse) for the debt. Otherwise, go to Part 2.		
1.	Enter the amount of outstanding debt immediately before the transfer of property reduced by any amount for which you remain personally liable immediately after the transfer of property	
2.	Enter the fair market value of the transferred property	
3.	**Ordinary income from the cancellation of debt upon foreclosure or repossession**. Subtract line 2 from line 1. If less than zero, enter zero. Next, go to Part 2	
Part 2. Figure your gain or loss from foreclosure or repossession.		
4.	If you completed Part 1, enter the smaller of line 1 or line 2. If you did not complete Part 1 enter the amount of outstanding debt immediately before the transfer of property	
5.	Enter any proceeds you received from the foreclosure sale	
6.	Add line 4 and 5	
7.	Enter the adjusted basis of the transferred property	
8.	**Gain or loss from foreclosure or repossession.** Subtract line 7 from line 6	

Foreclosure of Business and Investment Properties

Whether the foreclosed property is used for personal, business or investment, COD income can result at its foreclosure. However, the overall effect to the taxpayer differs. In the above example, Sharon lost her vacation home to foreclosure. The tax calculation resulted in $50,000 of ordinary income and $100,000 of non deductible personal loss. If instead of a vacation home, Sharon lost a rental house to foreclosure, she would still have $50,000 of COD income since the mortgage on the house exceeds the FMV by $50,000. But the loss would be a §1231 loss reported on the form 4797 as an ordinary loss. The net tax affect to Sharon would be an ordinary loss of $50,000 (which miraculously represents her true economic loss.)

Character of the Gain or Loss in a Foreclosure

Foreclosure gain or loss is governed by the normal gain or loss rules; that is, a capital asset creates a capital gain or loss, business assets create capital gain and ordinary loss, and dealer realty creates ordinary gain and loss. Sadly, foreclosure on a personal residence creates a nondeductible loss!

Example 1- Sharon loses Las Vegas rental property to foreclosure. In 2007, Sharon purchased a condo in Las Vegas for $450,000, with $50,000 down and a $400,000 recourse mortgage. Sharon expected to rent the condo for a few years and then make a killing when she sold it. Instead rental income was not enough to pay the mortgage payments, property taxes, condo fees and other expenses. Negative cash hurt a lot and then the property value plummeted to $250,000. Sharon stopped making payments and the bank foreclosed in 2010.

Sharon must report COD income of $150,000 ($400,000 loan less $250,000 FMV.) But Sharon will have an ordinary loss at the "sale" of the property. The FMV of the condo at its foreclosure becomes her sales price on the Form 4797, $250,000. She offsets the sales price with her adjusted basis in the property ($450,000 less depreciation claimed of say $20,000). Thus she'll report a ordinary loss of $180,000. Test that net taxable answer. Sharon put $50,000 down and wrote off $20,000 of depreciation. She lost real money of $30,000, the net between the COD of $150,000 and the loss on sale of $180,000.)

Example 2 - Bill loses apartment building acquired in an exchange to foreclosure. Bill exchanged a San Jose four-plex into a Phoenix apartment building. The $200,000 gain on the sale of relinquished property was deferred into the purchase price of the new property, reducing his basis accordingly. Although the apartment building has declined in value $300,000 since he purchased it, if Bill loses the property to foreclosure, he may have a gain on the "sale."

FACTS	
Purchase apartment building	$1,300,000
Down payment	$250,000
Mortgage	$1,050,000
Deferred gain	$200,000
Depreciation claimed	$125,000
FMV at foreclosure	$1,000,000

TAXABLE RESULT		
COD at foreclosure	$50,000	$1,050,000 mortgage less $1,000,000 FMV
Gain at "sale"	$25,000	$1,000,000 FMV less $975,000 adjusted basis. Gain is subject to depreciation recapture at 25%.

Short Pay or Short Sales–How Are They Taxed?

One phenomenon in a declining residential mortgage market is dubbed a "short pay" or a "short sale," that is, the home is sold for less than ("short of") what is owed on the mortgage. Property advertisements sometimes refer to it as a "pre-foreclosure" sale. While the home is marketed by the mortgage holder in a foreclosure, it is marketed by the homeowner in a short sale, generally with the disclosure "subject to lender approval." Often the lender agrees to the sale of mortgaged property by the debtor for an amount less than the outstanding debt. In addition, the debtor may be required to pay some cash to the lender.

> ***Planning Point:*** In a short pay transaction, the lender, not the property owner, makes the ultimate decision to sell. For the property owner, a short sale is sometimes better for his or her credit rating then going through foreclosure proceedings. For the lender, the short sale alternative cuts its losses faster than the protracted foreclosure process.

If the loan being extinguished is nonrecourse (perhaps the original purchase mortgage), the loan balance is treated as the sales price of the property. If the loan being extinguished is recourse, the excess of the property's loan over fair market value (FMV) is COD income. The FMV is treated as the sales price of the property.

> ***Preparer Point:*** It seems the debtor is merely selling the property on the lender's behalf (the lender must agree to the sale) and that the amount realized by the debtor is the amount of the debt pursuant to §1.1001-2(a)(1), as would be the case if the lender took back the property.

Short Sale Created Cancellation of Debt Income

Gerald and Sharon Stevens purchased a 2-story investment property in Chicago that needed rehabilitation, and, in 2002, found themselves unable to make the mortgage payments on the property. In order to avoid a foreclosure, which would have adversely affected their credit rating, they decided to sell the property in a short sale with the approval of Homecomings Financial. In February, 2003, the Stevens separated. Homecomings Financial mailed a Form 1099-C stating that the mortgage loan debt of $74,494 was canceled on March 27, 2003. The Stevens failed to report either the sale or the cancellation of indebtedness income. The court determined there was no capital loss and $74,494 of ordinary income from the discharge of indebtedness, since neither of the

Stevens presented any evidence to the contrary (***Gerard Eugene Stevens v. Comm***., TCS 2008-61).

Lenders Participating in Short Sales Give Up Deficiency Judgments in CA

SB 931 (Ducheny, Stats. 2010, Ch. 701) amended §580e of the Code of Civil Procedure to prohibit a deficiency judgment under a note secured by a first deed of trust or first mortgage for a dwelling of not more than 4 units in any case in which the trustor or mortgagor sells the dwelling for less than the remaining amount of the indebtedness due at the time of sale with the written consent of the holder of the first deed of trust or first mortgage. This prohibition against deficiency for first mortgages took effect January 1, 2011.

In July 2011, SB 458 (Corbett, Stats. 2011, Ch. 82) further amended §580e to apply the prohibition against deficiency judgments to apply to any mortgage or lien holder who consents to a short sale. This provision became effective July 15, 2011.

IRS Chief Counsel Tells Senator Boxer That California's Short Sale Laws Change Loans to Nonrecourse

In August 2013 US Senator Barbara Boxer asked the IRS if the above changes to CCP Section 580e meant that the underlying loan would be treated as nonrecourse for purposes of determining cancellation of debt (COD) income. In a response dated September 19, 2013 IRS Chief Counsel replied: "We believe that a homeowner's obligation under the anti-deficiency provision of section 580e of the CCP would be a nonrecourse obligation to the extent that, for federal income tax purposes, the homeowner will not have cancellation of indebtedness income. Instead, the homeowner must include the full amount of the nonrecourse indebtedness in amount realized."

FTB agrees with IRS letter. On December 4, 2013, FTB Chief Counsel wrote in a letter to State Board of Equalization Member George Runner that "Since California conform to the relevant portions of the federal tax law governing the forgiveness of nonrecourse and recourse indebtedness, California would follow the federal treatment for the CCP section 580e transactions. As such, the homeowner may have gain on the short sale, but would not have cancellation of indebtedness income."

Exception to the COD Income Rule– §108 Relief

The Supreme Court long ago formulated the principle that increases in net worth from forgiveness or cancellation of indebtedness give rise to gross income, United States v. Kirby Lumber Co., 284 U.S. 1 (1931), but there are recognized exceptions to this general principle. The Court of Appeals for the Fifth Circuit was among the first Courts of Appeals to develop an "insolvency exception," in *Dallas Transfer & Terminal Warehouse Co. v. Commissioner*, 70 F.2d 95 (5th Cir. 1934), revg. 27 B.T.A. 651 (1933).

In *Dallas Transfer,* the taxpayer's relief from indebtedness did not result in gross income where he was insolvent both before and after the debt was discharged. The court stated: This (relief from indebtedness) does not result in the debtor acquiring something of exchangeable value in addition to what he had before. There is a reduction or extinguishment of liabilities without any increase of assets. There is an absence of such a gain or profit as is required to come within the accepted definition of income.

Section 108, Income from Discharge of Indebtedness, codifies the result reached in *Dallas Transfer*, and identifies in subsection (a), Exclusions From Gross Income, situations in which discharge of indebtedness is not included in gross income.

Exclusion from Income (§108)

COD is excludable from income if it occurs:

1. In bankruptcy,
2. To an insolvent borrower, but only to the extent of insolvency,
3. With qualified farm debt,
4. With qualified real property business debt (for taxpayers other than C corporations (§108(a)),
5. With seller financing (§108(e)(5)),
6. When payment of the debt would result in a tax deduction to the borrower (§108(e)(2)),
7. With certain student loans (§108(f)), or
8. Bona fide dispute.

Bankruptcy

Income from the discharge of debt incurred by a taxpayer in bankruptcy is excluded from income altogether, provided the bankruptcy case is not dismissed prior to debt discharge. However, to the extent available, a certain amount of a borrower's future tax benefits (called tax attributes) will be reduced. This exclusion from income is allowed, though, regardless of whether the amount of such income exceeds the borrower's future tax benefits (tax attributes) available for reduction [§108(a)(1)(A); §108(b)].

Taxpayer is Insolvent

Gross income does not include COD income when the borrower is insolvent. However, the amount excluded cannot exceed the amount by which the borrower is insolvent. Certain of the borrower's future tax benefits (i.e., tax attributes) must be reduced by the amount of income excluded under this insolvency exception. If a taxpayer is bankrupt and insolvent, only the bankruptcy exclusion applies. If the borrower remains insolvent after the discharge, all income from the discharge is permanently excluded, regardless of whether the amount of such income exceeds the amount of future tax benefits (i.e., tax attributes) available for reduction [§108(a)(1)(B); §108(a)(3); §108(b)].

What is insolvency? Being insolvent means the investor's liabilities exceed the fair market value (FMV) of his or her assets determined immediately before the discharge (i.e., FMV assets less liabilities equals a negative number).

> ***Example.*** Jon has assets with a fair market value of $200,000 and has liabilities of $250,000, the amount by which he is insolvent is $50,000. Therefore, if the liabilities were discharged, only $50,000 can be excluded from gross income.

How to calculate insolvency. Unlike bankruptcy, insolvency is much more difficult to determine. The Code defines insolvency as the excess of liabilities over the fair market value of assets (§108(d)(3)). Thus the taxpayer must prepare a balance sheet (showing all assets including personal residence, pension plan and IRA accounts at their fair market value) in order to determine the amount of insolvency and the availability of this COD exclusion. The taxpayer has the burden of proving insolvency. Appraisals and business valuations may be required.

Nonrecourse debt is included in this calculation only when it is involved in the debt discharge transaction itself, and in such cases only the amount discharged is counted [§108(d)(3); Rev. Rul. 92-53, 1992-27 IRB].

> ***Planning Point.*** Contingent liabilities are not included in the insolvency computation (see Dudley B. Merkel V. Comm., 109 TC 463, aff'd, CA-9, 99-2 USTC 50,848, 192 F3d 844).

Property Protected from Creditor Claims in Bankruptcy Included in Calculation of Insolvency

Although bankruptcy law protects pension funds from creditor claims, pension funds are included in assets for calculating insolvency (see PLR 199932013 and 199935002). This is also true of residences protected from creditor claims, such as in California (Stuart Raymond Quartemont v. Comm., TCS 2007-19).

IRS Issues New Insolvency Worksheet

A comprehensive new insolvency worksheet tax practitioners can use to determine whether and to what extent taxpayers are insolvent is included in the newly revised edition of Publication 4681, Canceled Debts, Foreclosures, Repossessions, and Abandonments (for Individuals). The result can then be used to determine whether and to what extent the canceled debts are excluded from gross income.

COD Income Is Excluded If the Canceled Debt Is "Qualified Farm Debt"

Section 108 provides an exclusion for the cancellation of qualified farm debt owed to a qualified person. This exclusion applies only if the farmer was solvent when the debt was canceled or, if the farmer was insolvent, only to the extent the canceled debt is more than the amount by which he was insolvent. This exclusion does not apply to a canceled debt excluded from income because it takes place in a bankruptcy case.

The debt is qualified farm debt if both the following requirements are met.

1. It was incurred directly in operating a farming business.

2. At least 50% of the farmer's total gross receipts for the 3 tax years preceding the year of debt cancellation were from a farming business.

A qualified lender is a person who is actively and regularly engaged in the business of lending money. A qualified person includes any federal, state, or local government, or any of their agencies or subdivisions. The USDA is a qualified person. A qualified person does not include any of the following.

1. A person related to the farm borrower.
2. A person from whom the farmer got the property (or a person related to this person).
3. A person who receives a fee from the farmer's investment in the property (or a person related to this person).

Payment of the Liability Would Have Given Rise to a Deduction

Interest expense owed to the lender and forgiven in the foreclosure is not necessarily COD income. The forgiven interest expense is excludable under §108 if it would be deductible on the borrower's tax return (§108(e)(2)).

Example: Cameron has stopped making mortgage payments. She owes the lender $4,000 of interest on her loan when her property is foreclosed, in addition to the unpaid principal balance. Even though there has been a $4,000 cancellation of debt, Cameron may exclude the COD income if the payment for interest is a deductible expense (e.g. it is interest paid on the acquisition mortgage for her personal residence.) In addition, there is no reduction of any future tax benefits or tax attributes.

Discharge of Real Property Business Debt

Some debt relief on real property may not be COD income. Taxpayers, other than C corporations, are granted the option of excluding COD from income if the discharge is of qualified real property business indebtedness. Any amount excluded is treated as a reduction in the basis of that property (therefore, the future depreciation will be lower and the gain on sale will be larger). The reduction to basis cannot exceed the basis of certain depreciable real property of the taxpayer (§108(a)(1)(D))

Example: Robert purchases a $1,000,000 office building financed by a $900,000 mortgage from the Last Chance S&L and $100,000 of his own cash. Afterward, the property value plummets to $700,000 and Robert goes to his friendly loan officer and says "You can have this pig back." The loan officer, as an alternative, offers to reduce Robert's loan from $900,000 to $700,000 if he continues to make the agreed monthly payments. Robert accepts. If Robert properly elects, he may simply reduce his depreciable basis by $200,000 and avoid COD income.

Required qualifications. *Qualified real property business indebtedness (QRPBI)* is debt that meets the following three requirements:

1. The debt is incurred or assumed in connection with the acquisition of real property used in a trade or business (but qualified farm debt cannot be QRPBI).

2. The debt is secured by that real property.

   Tax Tip: Secured debt is defined as a security instrument (such as a mortgage, deed of trust, or land contract), and (1) the qualified property is specific security for the payment of the debt; (2) in the event of default, the property could be subject to the satisfaction of the debt; and (3) it is recorded [§1.163-10T(o)(1)].

3. The taxpayer makes a proper election.

The election must be made on Form 982. Regulations provide that Form 982 must be attached to the return as originally filed for the year in which the discharge occurred. However, a taxpayer who can show reasonable cause can file the election with an amended return. The revised form includes a new check box to make the election (box 1d) and a line (line 4) to indicate the amount to be applied against depreciable basis [IRS Ann. 94-11, 1994-3 IRB and Temp. regulation 1.108(c)-1T].

Reduction of Future Tax Attributes

In the absence of an election first to reduce depreciable basis, future tax benefits (tax attributes) of the borrower shall be reduced to the extent of debt discharge income (or its equivalent) in the following order:

1. *Net operating losses:* Reduce NOL dollar for dollar.
2. *General business credit:* Reduce at a 33.3% rate for each dollar of COD excluded.
3. *Alternative minimum tax credits:* Reduce the minimum tax credits as of the beginning of the tax year *immediately* after the tax year of the discharge.
4. *Capital losses:* Reduce dollar for dollar.
5. *Basis reduction:* Reduce, dollar for dollar, the basis of both depreciable and *nondepreciable* property. But this basis cannot be reduced below total liabilities immediately after the discharge [§108(b)(2)(D)].
6. *Passive activity losses (and credits):* Reduce the passive activity losses and credit carryovers from the tax year of the discharge.
7. *Foreign tax credit carryovers:* Reduce at a 33.3% rate for each dollar of COD excluded.

The price of fun – basis reduction requires recapture (an increased amount of taxable gain) when the property is sold in the future. If the basis of a property is reduced and the property is later sold (or otherwise disposed of) at a gain, the part of the gain created by the COD basis reduction is taxable as ordinary income, not capital gain. This is Congress's way of giving the taxpayer a current benefit at the time of the COD but ensuring recapture of that added benefit when the taxpayer later sells the property (preferably for cash, as this could result in 100% of the sales price being taxable as ordinary income) [§1017(d)].

Cancellation of Acquisition Indebtedness on Principal Residences

Ten Facts about Mortgage Debt Forgiveness

Here are 10 facts the IRS wants you to know if your client's personal residence is foreclosed (IR 2010-44).

IRS Top Ten

1. Normally, debt forgiveness results in taxable income. However, under the Mortgage Forgiveness Debt Relief Act of 2007, the taxpayer may be able to exclude up to $2 million of debt forgiven on his or her principal residence.
2. The limit is $1 million for a married person filing a separate return.
3. The taxpayer may exclude debt reduced through mortgage restructuring, as well as mortgage debt forgiven in a foreclosure.
4. To qualify, the debt must have been used to buy, build or substantially improve the taxpayer's principal residence and be secured by that residence.
5. Refinanced debt proceeds used for the purpose of substantially improving the taxpayer's principal residence also qualify for the exclusion.
6. Proceeds of refinanced debt used for other purposes – for example, to pay off credit card debt – do not qualify for the exclusion.
7. If the homeowner qualifies, claim the special exclusion by filling out Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness, and attach it to his or her federal income tax return for the tax year in which the qualified debt was forgiven.
8. Debt forgiven on second homes, rental property, business property, credit cards or car loans does not qualify for the tax relief provision. In some cases, however, other tax relief provisions – such as insolvency – may be applicable. IRS Form 982 provides more details about these provisions.
9. If the debt is reduced or eliminated the homeowner normally will receive a year-end statement, Form 1099-C, Cancellation of Debt, from the lender. By law, this form must show the amount of debt forgiven and the fair market value of any property foreclosed.
10. Examine the Form 1099-C carefully. Notify the lender immediately if any of the information shown is incorrect. You should pay particular attention to the amount of debt forgiven in Box 2 as well as the value listed for the home in Box 7.

Mortgage Forgiveness Debt Relief Act of 2007

A taxpayer subject to foreclosure might end up homeless and still face a nasty tax bill from Uncle Sam for cancellation of debt income. To address this looming tax dilemma, Congress retroactively added a new §108 exclusion to cancellation of debt income. Effective for discharges of indebtedness on or after January 1, 2007 and before December 31, 2012, the Mortgage Forgiveness Debt Relief Act of 2007 (H.R. 3648) excludes from a taxpayer's gross income any discharge (in whole or in part) of qualified principal residence indebtedness (new §108(a)(1)(E)).

Principal Residence COD Exclusion Extended 1 Year

The American Taxpayer Relief Act of 2012 extended relief from discharges of qualified acquisition indebtedness through December 31, 2013.

Qualified Principal Residence Indebtedness

Qualified principal residence indebtedness means acquisition indebtedness [within the meaning of §163(h)(3)(B) except that the dollar limit is $2 million ($1 million in the case of a separate return) with respect to the taxpayer's principal residence.] Qualified principal residence indebtedness does not include home equity indebtedness.

Acquisition indebtedness with respect to a principal residence generally means indebtedness which is incurred in the acquisition, construction, or substantial improvement of the principal residence by the individual and is secured by the residence. It also includes refinancing of such indebtedness to the extent the amount of the refinancing does not exceed the amount of the refinanced indebtedness.

> **Note**: For these purposes the term "principal residence" has the same meaning as under §121. It does not include the taxpayer's vacation home, rental or investment property.

When a portion of the mortgage is acquisition indebtedness. If, immediately before the discharge, only a portion of a discharged indebtedness is qualified principal residence indebtedness, the exclusion applies only to so much of the amount discharged as exceeds the portion of the debt which is not qualified principal residence indebtedness.

Example. In 2005, Sharon purchased her personal residence in Livermore, California for $700,000. She made a $100,000 down payment and financed $600,000. A year later she used a $200,000 home equity line to finance her kitchen remodeling. In 2007 she refinanced the property for $1 million and used the proceeds to pay off personal debts and finance her son's Stanford tuition. In 2008, the value of the property has dropped well below the $1 million mortgage. Sharon stops making payments on her loan, the property is foreclosed and sold at auction for $700,000. What are Sharon's tax consequences?

If the residence is sold for $700,000 and $300,000 of the debt is discharged, only $100,000 of the amount discharged may be excluded from Sharon's gross income under the new law. The $200,000 COD in excess of "qualified acquisition indebtedness" is taxable as ordinary income unless Sharon is bankrupt or insolvent.

> **Warning**: Homeowners who refinanced their principal residence mortgage to pay off personal credit card debts, car loans or for other personal uses are not entitled to this new exclusion and will have cancellation of debt income.

Basis Reduction

The basis of the individual's principal residence is reduced by the amount excluded from income, the theory being that his reduction will be subsequently reported as additional gain upon a future sale. Of course, this would only happen if the gain exceeds $250,000/$500,000 MFJ.

> ***Example***. Karen bought her home in Riverside California for $600,000. She financed the purchase with a $540,000 first mortgage and a $60,000 second mortgage. The value of her home has dropped below the first mortgage balance. Karen talks the second mortgage lender into writing off its $60,000 note. Thus she has COD income of $60,000 and she'll receive a form 1099-C from the lender. The $60,000 COD can be excluded under the new law but Karen's basis in her home will be reduced by the excluded amount. Her basis will be $540,000 rather than $600,000.

Bankrupt or Insolvent Taxpayers

The exclusion does not apply to a taxpayer in a Title 11 bankruptcy case; instead the present-law exclusion at §108(a)(1)(A) applies. In the case of an insolvent taxpayer not in bankruptcy, the exclusion under the bill applies unless the taxpayer elects to have the present-law exclusion at §108(a)(1)(B) apply.

Discharge of Indebtedness in Exchange for Services Rendered

The exclusion does not apply to the discharge of a loan if the discharge is on account of services performed for the lender.

Mortgage Modification

Not all troubled homeowners will lose their house to foreclosure some will be able to work out a loan modification with the lender. A loan modification still results in cancellation of debt and therefore the potential of taxable income.

> ***Example.*** In 2005, Nancy purchased a principal residence for $435,000. Nancy took out a $420,000 mortgage loan to buy the principal residence and made a down payment of $15,000. The loan was secured by the principal residence. The mortgage loan was a recourse debt, meaning that Nancy was personally liable for the debt. In 2004, Nancy took out a second mortgage loan (also a recourse debt) in the amount of $30,000 that was used to substantially improve her kitchen.
>
> In 2007, when the outstanding principal of the first and second mortgage loans was $440,000, Nancy refinanced the two recourse loans into one recourse loan in the amount of $475,000. The FMV of Nancy's principal residence at the time of the refinancing was $500,000. Nancy used the additional $35,000 debt ($475,000 new mortgage loan minus $440,000 outstanding principal of Nancy's first and second mortgage loans immediately before the refinancing) to pay off personal credit cards and to pay college tuition for her son. After the refinancing, Nancy has qualified principal residence indebtedness in the amount of $440,000 because the refinanced debt is

qualified principal residence indebtedness only to the extent the amount of debt does not exceed the amount of refinanced debt.

In 2010, Nancy was unable to make her mortgage loan payments. On August 31, 2010, when the outstanding balance of her refinanced mortgage loan was still $475,000 and the FMV of the property was $425,000, Nancy's bank agreed to a loan modification (a "workout") that resulted in a $40,000 reduction in the principal balance of her loan. Nancy was neither insolvent nor in bankruptcy at the time of the cancellation.

Nancy received a 2010 Form 1099-C from her bank on January 31, 2011, showing canceled debt of $40,000 in box 2. To determine if she must include the canceled debt in her income, Nancy must determine whether she meets any of the exceptions or exclusions that apply to canceled debts. Nancy determines that the only exception or exclusion that applies to her is the qualified principal residence indebtedness exclusion.

Next, Nancy determines the amount, if any, of the $40,000 of canceled debt that was qualified principal residence indebtedness. Although Nancy has $440,000 of qualified principal residence indebtedness, part of her loan ($35,000) was not qualified principal residence indebtedness because it was used to pay off personal credit cards and college tuition for her son. Applying the ordering rule, the qualified principal residence indebtedness exclusion applies only to the extent the amount canceled exceeds the amount of the debt (immediately before the cancellation) that is not qualified principal residence indebtedness. Thus, Nancy can exclude only $5,000 of the canceled debt as qualified principal residence indebtedness ($40,000 amount canceled minus $35,000 nonqualified debt).

Because Nancy does not meet any other exception or exclusion, Nancy checks only the box on line 1e of Form 982 and enters $5,000 on line 2. Nancy must also enter $5,000 on line 10b and reduce the basis of her principal residence by the $5,000 that she excluded from income, bringing the adjusted basis in her principal residence to $460,000 ($435,000 purchase price plus $30,000 substantial improvement minus $5,000). Nancy must also include the $35,000 nonqualified debt portion in income on Form 1040, line 21.

Checklist for Exclusion of Cancellation of Home Mortgage Indebtedness	
Must be principal residence as defined under §121	√
Must be acquisition indebtedness as defined in §163 √original or refinanced debt √used for acquisition, construction or improvement of principal residence √debt not used for personal purposes √secured by the principal residence √recourse debt [1] √under $2 million	√
Homeowner has not filed bankruptcy	√
If homeowner is insolvent, may elect to use this provision	√
Cancellation is not for personal services rendered	√

[1] Nonrecourse loans forgiven in foreclosure are treated as the sales price of the property. Thus no cancellation of debt income occurs. The new law is to protect homeowners with recourse financing from cancellation of debt income.

Passive Activities

What's a passive activity?

1. ***A rental activity*** without regard to whether or to what extent the taxpayer participates in such activity (therefore, a rental activity is treated as a passive activity, regardless of the level of the taxpayer's participation) and

2. ***A trade or business activity in which the taxpayer does not materially participate*** for the taxable year (§469(c)(1)).

Rental Real Estate

Rental activity is treated as a per se passive activity regardless of whether the taxpayer materially participates (§469(c)(2), (4)). But, the rental activities of a taxpayer in the real property business (real estate professional) are not per se passive activities under §469(c)(2) but are treated as a trade or business and subject to the material participation requirements of §469(c)(1) [§469(c)(7)(B)].

Limits on Passive Activity Deductions and Credits

Deductions for losses from passive activities are limited. You generally cannot offset income, other than passive income, with losses from passive activities. Nor can you offset taxes on income, other than passive income, with credits resulting from passive activities. Any excess loss or credit is carried forward to the next tax year

Losses from Rental Real Estate Activities

If the taxpayer actively participated in a passive rental real estate activity, he or she can deduct up to $25,000 of loss from the activity from nonpassive income. This special allowance is an exception to the general rule disallowing losses in excess of income from passive activities. Similarly, taxpayers can offset credits from the activity against the tax on up to $25,000 of nonpassive income after taking into account any losses allowed under this exception.

For married taxpayers, filing a separate return, who lived apart for the entire tax year, the special allowance cannot be more than $12,500. If a married taxpayer lived with his/her spouse at any time during the year and files a separate return, that taxpayer cannot use the special allowance to reduce nonpassive income or tax on nonpassive income.

The maximum amount of the special allowance is reduced if modified adjusted gross income is more than $100,000 ($50,000 if married filing separately).

Active Participation

A taxpayer actively participated in a rental real estate activity if the taxpayer (and his/her spouse) owned at least 10% of the rental property and made management decisions in a significant and *bona fide* sense. Management decisions include approving new tenants, deciding on rental terms, approving expenditures, and similar decisions.

Activities That Are Not Rental Activities (§1.469-1T(e)(3))

When is a rental activity really a business? The real complexity of the passive loss rules, in light of the above definition, is in making the determination whether a particular activity is a "rental activity," a "trade or business," or an "investment." The regulations exclude from the definition of a rental activity those activities in which the importance of providing services to customers outweighs the importance of providing tangible property to customers (e.g., a hotel is normally a business, not a rental activity). It is important to note that substance controls over form, and the use of legal documents stating that a relationship is a lease is irrelevant.

The Regulations have identified certain rental activities as not being passive rental activities. These include activities where:

1. **The average period of customer use is seven days or less.** Those renting vacation homes may fall under this exception.
2. **The average period of customer use is thirty days or less and significant personal services are provided by or on behalf of the owner of the property.** For example, significant personal services includes maid or linen services. Certain services are specifically excluded, such as cleaning public entrances, stairways, or lobbies and collecting and removing trash.
3. **Extraordinary personal services are provided by or on behalf of the owner of the property.** For example, a hospital room.
4. **The rental of such property is treated as incidental to a non-rental activity of the taxpayer.** This exception applies to property rented to employees at the employers convenience and investment property that is held primarily for appreciation and the gross rental income from the property is less than two percent of the lesser of the unadjusted basis or the fair market value of such property.
5. **The taxpayer customarily makes the property available during defined business hours for non-exclusive use by various customers.** An example of this would be a golf course.
6. **The provision of the property for use in an activity conducted by a partnership, S corporation, or joint venture in which the taxpayer owns an interest.**

What is an Activity For Passive Loss Purposes?

Is it each business separately? Or when the client owns two or more businesses, can he "group" them into one activity so that he is able to meet the material participation test?

Combining, or separating, multiple businesses properly, a tax disaster if taxpayer does this wrong! When applying the passive loss rules, the first, and most important, determination made by a taxpayer is defining how many different businesses (i.e., activities) the taxpayer must report to the IRS on the Passive Activity Form 8582. The taxpayer may aggregate, for passive loss purposes, two or more activities reported separately elsewhere on his or her tax return (§1.469-4(c)). But defining separate activities too narrowly, or too broadly, can either lead to evasion of the passive loss rules or, more tragically, make it impossible for the investor to take advantage of the relief provisions afforded him or her under the passive loss regulations.

Reasons for identifying each activity.

It is also necessary to identify every separate activity of a taxpayer for the following purposes:

- For determining whether the activity is a rental activity;
- For determining whether the taxpayer materially participates in the activity (may make it easier to meet the 500 hour test if the activity is a trade or business);
- For determining whether the taxpayer has completely disposed of his or her entire interest in the activity (to ascertain if the triggering of loss occurs); and
- For applying the transitional rules for pre-enactment interests in passive activities.

The Recharacterization Rules and Self-Rented Property

Renting Property to the Taxpayer's Own Business

Gross rental income equal to net rental income (including any income from a sale) is recharacterized as active income if the property is rented to a trade or business activity in which the taxpayer materially participates for the taxable year (without regard to the limited partner rules) so long as the property is not property rented incidental to a development activity [Reg. §1.469-2(f)(6); Reg. §1.469-2(f)(9)(iii)].

> ***Planning Point!*** This rule negatively impacts more taxpayers than any other recharacterization rule (see *Thomas and Ermina Krukowski v. Comm.*, (CA-7) 2002-1 USTC ¶50,219). It is intended to deter taxpayers from attempting to generate passive rental income and active business rental deductions by establishing rental arrangements between their own businesses.

The Ninth Circuit has upheld the validity of the regulation which re-characterizes self-rental income as non-passive for purposes of the passive loss (PAL) rules. As a result, the taxpayers could not use losses from their rental properties to offset rental income earned from their wholly owned businesses (*Gary Beecher & Delores Beecher v. Comm.*, No.-71894 (9th Cir, 3/23/2007); 99 AFTR 2d ¶2002-712).

> ***Note:*** The self-rental rule blocks a taxpayer with passive activity losses from one activity from artificially creating passive activity income from another activity in order to absorb the losses.

Passive Recharacterization Rules Stop Rental Losses from One Company from Offsetting Rental Income of Another

(*Joseph Veriha v Comm.*, USTC, 139 TC No. 3, No. 7099-10, Aug. 8, 2012)

JVT (Trucking) Company. Joseph Veriha is the sole owner of John Veriha Trucking, Inc. (JVT), a corporation with its principal place of business in Wisconsin. JVT was a C corporation during 2005 but has since elected S corporation status. Mr. And Mrs. Veriha were both employed by JVT during 2005, and Mr. Veriha materially participated in JVT's business. JVT is a trucking company that leases its tractors and trailers from two different entities: Transportation Resources, Inc. (TRI), and JRV Leasing, LLC (JRV).

TRI (leasing) company. TRI is an S corporation 99% of which is owned by Mr. Veriha. TRI has no business activities other than leasing equipment to JVT. TRI and JVT entered into 125 separate lease agreements in 2005, one for each tractor or trailer leased. TRI generated net income in 2005 which it reported to Mr. Veriha on a Schedule K-1. Mr. Veriha treated that net income as passive income on his return.

JRV (leasing) company. JRV is a single-member LLC, and Mr. Veriha is its sole member. JRV's only business activity was leasing tractors and trailers to JVT. JRV and JVT entered into 66 separate lease agreements in 2005, one for each tractor or trailer leased. JRV generated a net loss in 2005 which Mr. Veriha reported on his Schedule C. He treated the loss as a passive loss.

Income from TRI recharacterized. The Court agreed with the IRS determination that Mr. Veriha's income from TRI should be recharacterized as nonpassive income. As a result, the income from TRI is taxable, and the losses from JRV were suspended.

> ***Warning.*** The Court cautioned that it could deem each rental transaction (125 in TRI) as an activity for purposes of recharacterization. It did not but rather treated each company as an activity. Perhaps one lease for each business, rather than one for each piece of equipment, would provide an argument against this attack.

How could the taxpayer solve the problem?
The loss needs to be minimized or eliminated. Consider: 1) increase rents, 2) contribute some assets from JRV (the LLC) to TRI (the S corporation) to move losing assets to the profitable company, or 3) contribute all assets from JRV to TRI (consolidate the two leasing entities). Watch for relief of liability when considering the transfers. Also do not transfer assets and liabilities from the S corporation to the LLC, or tax may result on the liquidation.

Rental Income From Building Rented to Doctor's Medical Corporation is Recharacterized and is Not Passive Income

L.A. Samarasinghe is an employee of his wholly owned professional corporation, L.A. Samarasinghe, M.D., P.A. (medical corporation). In 1979 Dr. Samarasinghe purchased a building in his and his wife's name and rented it to his corporation. Dr. Samarasinghe characterized the rental income attributable to his rental of the building to the medical corporation during 2005 and 2007 as passive income and, in preparing his 2005 and 2007 returns, offset that income with passive losses. The IRS recharacterized the rental income as nonpassive income, determining that the income was self-rental income (*L.A. and Rayani Samarasinghev, Comm.,* TCM 2012-23)
.

Pre-1988 transition rule for rentals to C corporations. The recharacterization rule is not limited to rental arrangements with passthrough entities such as partnerships and S corporations. The Tax Court has required rental income from a C corporation to be recharacterized as nonpassive (active) if the taxpayer receiving the income materially participated in the C corporation's trade or business (Chester and Faye Sidell, (CA-1); Thomas Krukowski v. Comm., (CA-7)). A transition rule exempts rentals pursuant to a written binding contract entered into before February 19, 1988 (§1.469-11(c)(1)(ii)). But as discussed in the next paragraph, any subsequent change in the terms of a lease will be viewed as a series of different leases and not a continuation of the original lease.

To use the pre-1988 written binding contract exception argument, the pre-1988 provision cannot have changed. Because the corporation leased the medical building from Dr. Samarasinghe in 1980, he tried to argue that the self-rental rule didn't apply. Pursuant to §1.469-2(f)(6), a taxpayer's rental income is passive if it is attributable to the rental of property "pursuant to a written binding contract entered into before February 19, 1988." The Court determined that the 1980 lease was not in effect in the years under audit. The parties to the lease ignored the lease provision with respect to the amount of required rent and that monthly rent payments be made. The term of the lease, which originally ran from July 1 through June 30, appeared to have been changed to a term corresponding to the fiscal year of the medical corporation. The rental expense deducted on the medical corporation's returns for the taxable years ended in 2005 and 2007 did not coincide with what should have been reported under the 1980 lease if it were still in effect for those years. Thus, the court determined, the written binding lease exception did not apply and the rental income was recharacterized as non passive income.

> ***Preparer point.*** Check each year on a self-rented property. Losses are passive and income is non passive. The computer input sheet needs to be marked accordingly.

Previously held court decisions: Similar decisions have been reached in other circuits:

1. Seventh: *Krukowski v. Comm.*, (CA7 2002), 279 F.3rd 547; 89 AFTR 2d 2002-827
2. First: *Sidell v. Comm.*, (CA1 2000), 225 F3d 103; 86 AFTR 2d 2000-6229
3. Fifth: *Fransen v U.S.*, (CA5 1999), 191 F3d 599; 84 AFTR 2d 99-6360

Disposing of a Passive Activity

If during the taxable year a taxpayer disposes of his/her entire interest in any passive activity (or former passive activity) in a fully taxable transaction, any suspended losses associated with that activity are released (IRC §469(g)). In general, the sale of the activity must be to an unrelated party at fair market value.

If the sale of the passive activity is to a related party, then the taxpayer is not allowed release of suspended losses in the year of sale. Suspended losses continue to be deductible against passive income in subsequent years. Remaining losses are triggered when the related party disposes of the activity to an unrelated third party (IRC§469(g)(1)(B)).

Installment Sales
In the case of an installment sale of an entire interest in an activity, a portion of the suspended losses are allowed each year in the same proportion as the gain recognized during such taxable year bears to the gross profit from the sale (IRC §469(g)(3)).

Gifts
A gift of an activity with suspended passive losses does not trigger those losses. The basis of the property immediately before the transfer is increased by the amount of any suspended passive activity losses. This adjusted basis becomes the basis in the hands of the recipient (IRC §469(j)(6)(A)).

Death of the Taxpayer
If an interest in a passive activity with suspended losses is transferred at the death of the taxpayer, the suspended losses in excess of the step-up basis adjustment for the asset are allowed on the decedent's final tax return. The remainder of the suspended losses are eliminated.

Example. Tom owns a residential rental property with adjusted basis of $100,000 and a fair market value of $150,000. In the year of his death, he has $30,000 suspended losses for this activity. Because the losses are less than the step-up in basis ($50,000) none of the losses are released on Tom's final 1040 and the losses are eliminated.

Suppose Tom had $60,000 suspended losses at the time of his death. In that case $10,000 ($60,000 losses less $50,000 step-up basis) would be released on Tom's final 1040. The remaining $50,000 in losses will vanish.

Converting Rental Property to Principal Residence
When a taxpayer converts a rental unit into his/her principal residence, suspended losses from the passive rental activity remain suspended. They can be deducted against other passive income in future years (IRC §469(f)). If the home is eventually sold, it no longer qualifies as a passive activity and the disposition will not trigger the remaining suspended losses except to the extent of the unrecaptured §1250 gain recognized.

Real Estate Professionals
A taxpayer's rental real estate activities in which he or she materially participates are not subject to limitation under the passive loss rules if the taxpayer meets eligibility requirements relating to real property trades or businesses in which the taxpayer performs services. This means that those real estate investors who qualify are permitted to deduct their rental real estate losses from their current commissions, wages, interest and dividends (§469(c)(7)).

Real Estate Professional Eligibility Requirements

The 50% test. More than 50% of the individual's personal services during the tax year must be performed in real property trades or businesses (defined below) in which the individual *materially* participates (defined below), and

The 750-hour test. The individual must perform more than 750 hours of service in those same trades or businesses (§469(c)(7)(B)).

Real Estate Businesses Can Be Combined

Real property trade or business means "any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business" (§469(c)(7)(C)). Use total time spent in any combination of these businesses to determine if the 50% test and the 750 hour test are met.

> ***Planning Tip**:* According to this passive loss relief provision, the "blessed" businesses generally include most (1) real estate builders and contractors, (2) owners of rentals, (3) property managers and (4) participants in the real estate brokerage business – if they meet the 50% participation and the 750-hour requirements. The professions of real estate appraiser and loan broker are excluded from using this favorable tax treatment.

> ***Planning Tip**:* Any hourly combination in these four "blessed" businesses is permitted; a taxpayer, for example, who spends 100 hours managing his or her rentals and 651 hours selling real estate exceeds the 750-hour minimum!

Finally! California Real Estate "Agent" is in a Real Estate Brokerage Business

Despite an ongoing position by IRS auditors that only someone holding a real estate broker's license in California can be considered in a "real estate brokerage trade or business" (§469(c)(7)(C)), the Tax Court held that married taxpayers qualified to deduct losses from rental real estate activities in which they materially participated based upon the wife's occupation as a real estate agent.

During 2001 and 2002 Shri Agarwal (Mr. Agarwal) worked full time as an engineer. During 2001 and 2002 Sudha Agarwal (Mrs. Agarwal) worked full time as a real estate agent at "Century 21 Albert Foulad Realty" (brokerage firm). During 2001 and 2002 Mrs. Agarwal was licensed as a real estate agent under California law; she was not licensed as a broker. She worked for a brokerage firm pursuant to an "Independent Contractor Agreement (Between Broker and Associate Licensee)." The contract provided that she was an independent contractor, not an employee of the brokerage firm. Consistent with Mrs. Agarwal's independent contractor status, the brokerage firm issued a Form 1099 to her for each year, and it did not pay her a salary; rather, she received commissions. The contract also required Mrs. Agarwal to sell, exchange, lease, or rent properties and solicit additional listings, clients, and customers diligently and with her best efforts.

During 2001 and 2002 petitioners owned two rental properties. Together they spent approximately 170 hours managing the “Wanda Property” and approximately 170 hours managing the “Mohave Property” during 2001 and 2002. They were the only persons who managed their rental properties. Mrs. Agarwal spent a total of 1,400 and 1,600 hours managing their rental properties and selling real estate in 2001 and 2002, respectively.

Section 469(c)(7)(C) defines the term “real property trade or business” as “any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or *brokerage* trade or business.” (Emphasis added.)

The IRS argued that Mrs. Agarwal was a licensed real estate agent, not a licensed real estate broker. Thus, under California law, according to the Service, Mrs. Agarwal could not be engaged in a brokerage trade or business, and therefore, she was not engaged in a real property trade or business as defined by section 469(c)(7)(C).

The term “brokerage” is not defined in section 469, within the legislative history of section 469, or by any court decision. Thus, the Court turned to principles of statutory construction to determine its meaning.

“Statutory words are uniformly presumed, unless the contrary appears, to be used in their ordinary and usual sense, and with the meaning commonly attributed to them” (*Caminetti v. United States*, 242 U.S. 470, 485-486 (1917)). In addition, a statutory term is construed “in its context and in light of the terms surrounding it” (*Leocal v. Ashcroft*, 543 U.S. 1, 9 (2004); see also *Jarecki v. G. D. Searle & Co.*, 367 U.S. 303, 307 (1961) ("a word is known by the company it keeps")). Legislatures are presumed to have intended that a statute’s terms “‘be given a reasonable construction’” (*Hazlett v. Evans*, 943 F. Supp. 785, 788 (E.D. Ky. 1996) (quoting *D.L.C. v. Walsh*, 908 S.W.2d 791 (Mo. Ct. App. 1995)).

A term’s common or approved usage may be established by a dictionary (*Rousey v. Jacoway*, 544 U.S. 320 (2005); *Smith v. United States*, 508 U.S. 223, 228-229 (1993)). *Webster's Third New International Dictionary* defines the term “brokerage” as “the business of a broker” or “the fee or commission for transacting business as a broker.”

The Court concluded that Congress is presumed to have defined the term “brokerage” in its common or ordinary meaning. The Court further concluded that for purposes of section 469, the “business” of a real estate broker includes, but is not limited to:

(1) selling, exchanging, purchasing, renting, or leasing real property;
(2) offering to do those activities;
(3) negotiating the terms of a real estate contract;
(4) listing of real property for sale, lease, or exchange; or
(5) procuring prospective sellers, purchasers, lessors, or lessees.

As is relevant here, California law defines the term “real estate broker” as a person who does, or negotiates to do, any one of the enumerated activities for compensation. (Cal. Bus. & Prof. Code sec. 10131 (West 2008)). Similarly, California law also defines the term “real estate salesman” as a person who is employed by a broker and who does any one of the enumerated activities. (Cal. Bus. & Prof. Code sec. 10132 (West 2008)). But the Court found that whether Mrs. Agarwal is characterized as a broker or a salesperson for State law purposes is irrelevant for Federal income tax purposes ―the test is whether she was engaged in “brokerage” within the meaning of section 469, as defined supra. Consistent with her real estate salesman’s license and pursuant to her contract with the brokerage firm, Mrs. Agarwal was engaged in “brokerage;” i.e., she sold, exchanged, leased, or rented real property and solicited listings. Therefore, Mrs. Agarwal was engaged in a “brokerage” trade or business within the meaning of section 469(c)(7)(C). (*Shri G. and Sudha Agarwal v. Commissioner*., (March 2, 2009) [T.C. Summary Opinion 2009-29])

Material Participation

An individual is treated as participating “materially” for the taxable year if the individual's participation meets one of the seven enumerated material participation tests (Reg. §1.469-5T(a)(1)-(7)). The three most common ways that real estate investors may meet this “material participation” test are by:

1. managing and operating the rental real estate activity for more than 500 hours during the year,
2. doing substantially all the work required to manage and operate the rental real estate during the year (probably more than 70% of the total business hours are performed by the landlord) or
3. working more than 100 hours during the year with no one (including nonowner employees and independent property managers) participating more than the landlord (§1.469-5T(a)(1)-(3)).

Substantiation of Time Requirement

With respect to the evidence that may be used to establish hours of participation, the extent of an individual’s participation in an activity may be established by any reasonable means. Contemporaneous daily time reports, logs, or similar documents are not required if the extent of such participation may be established by other reasonable means. Reasonable means for purposes of this paragraph may include but are not limited to the identification of services performed over a period of time and the approximate number of hours spent performing such services during such period, based on appointment books, calendars, or narrative summaries (§1.469-5T(f)(4)).

Aggregation of Rental Real Estate for Real Estate Professionals

Each Rental is a Separate Activity, Unless All Rentals are Combined.

Each interest of the taxpayer in rental real estate is to be considered as a separate activity, but a taxpayer may elect to treat all interests in real estate, including real estate held through pass-through entities, as one activity [§469(c)(7)(A)].

> ***Tax Tip****:* The aggregation option permits the investor to meet the material participation test after *cumulatively* materially participating (e.g., working 100 hours or 500 hours) *in all the real estate rentals*. Without the aggregation option, the investor would be required to materially participate (i.e., spend 100 hours or 500 hours) in ***each*** activity, probably an impossible task for investors owning more than four rentals!

> ***Tax Tip****:* When would investors *not* want to aggregate their rental real estate? When the rental real estate is throwing off passive income, and they purposely want to flunk this test! The rental real estate passive profit is then usable against other passive losses, such as other rentals in which they are not materially participating or vacation homes in rental pools in which they cannot materially participate.

The Election Must Be Properly Made

The election to treat all interests in rental real estate as a single rental real estate activity is binding for all future years unless there is a material change in a taxpayer's facts and circumstances. The taxpayer makes the election by filing a statement with his or her original income tax return. This statement must contain a declaration that the taxpayer is a qualifying taxpayer for the taxable year and is making the election pursuant to §469(c)(7)(A) [§1.469-9(g)]. A taxpayer may revoke the election only in the taxable year in which a material change in the taxpayer's facts and circumstances occurs or in a subsequent year in which the facts and circumstances remain materially changed from those in the taxable year for which the election was made. To revoke the election, the taxpayer must file a statement with the taxpayer's original income tax return for the year of revocation (§1.469-9(g)(3)).

Wording for Single Rental Real Estate Activity Election:

"In accordance with §1.469-9(g)(3), the taxpayer hereby states that he (or she) is a qualifying real estate professional under IRC §469(c)(7), and elects under IRC Sec. 469(c)(7)(A) to treat all interests in real estate as a single rental real estate activity."

Will The IRS Permit A Late Election?

The IRS has granted numerous extensions when the taxpayer intended to elect single rental real estate activity treatment but failed to include the required statement with the taxpayer's return, when the IRS determined the taxpayer had acted reasonably and in good faith, e.g., taxpayers relying on tax professionals who failed to advise them of the availability and benefits of the election (LTR 200816005; LTR 200722006; LTR 200606016; LTR 200606017).

IRS Allows Real Estate Professionals to Make Late Aggregation Election to Treat All Interests in Rental Real Estate as a Single Activity (Rev. Proc. 2011-34)

Eligibility for relief. A taxpayer is eligible for an extension of time to file this election late (under §1.469-9(g)) if the taxpayer represents on a statement, under penalties of perjury, that he or she meets all of the following requirements:

1. the only reason the aggregation election wasn't made is because taxpayer didn't file the required statement with his or her income tax return the first year the taxpayer became a real estate professional.
2. the taxpayer filed all required federal income tax returns consistent with the requested aggregation for all of the years including and following the year the taxpayer intends the requested aggregation to be effective and no tax returns containing positions inconsistent with the requested aggregation may have been filed by or with respect to the taxpayer during any of the taxable years;
3. the taxpayer timely filed each return that would have been affected by the election if it had been timely made. The taxpayer will be treated as having timely filed a required tax or information return if the return is filed within 6 months after its due date, excluding extensions; and
4. the taxpayer has reasonable cause for his or her failure to meet the these requirements (§1.469-9(g)).

Requesting relief on amended return. The taxpayer must attach the following statement to an amended return for the most recent tax year and mail the amended return to the IRS service center where the taxpayer will file its current year tax return.

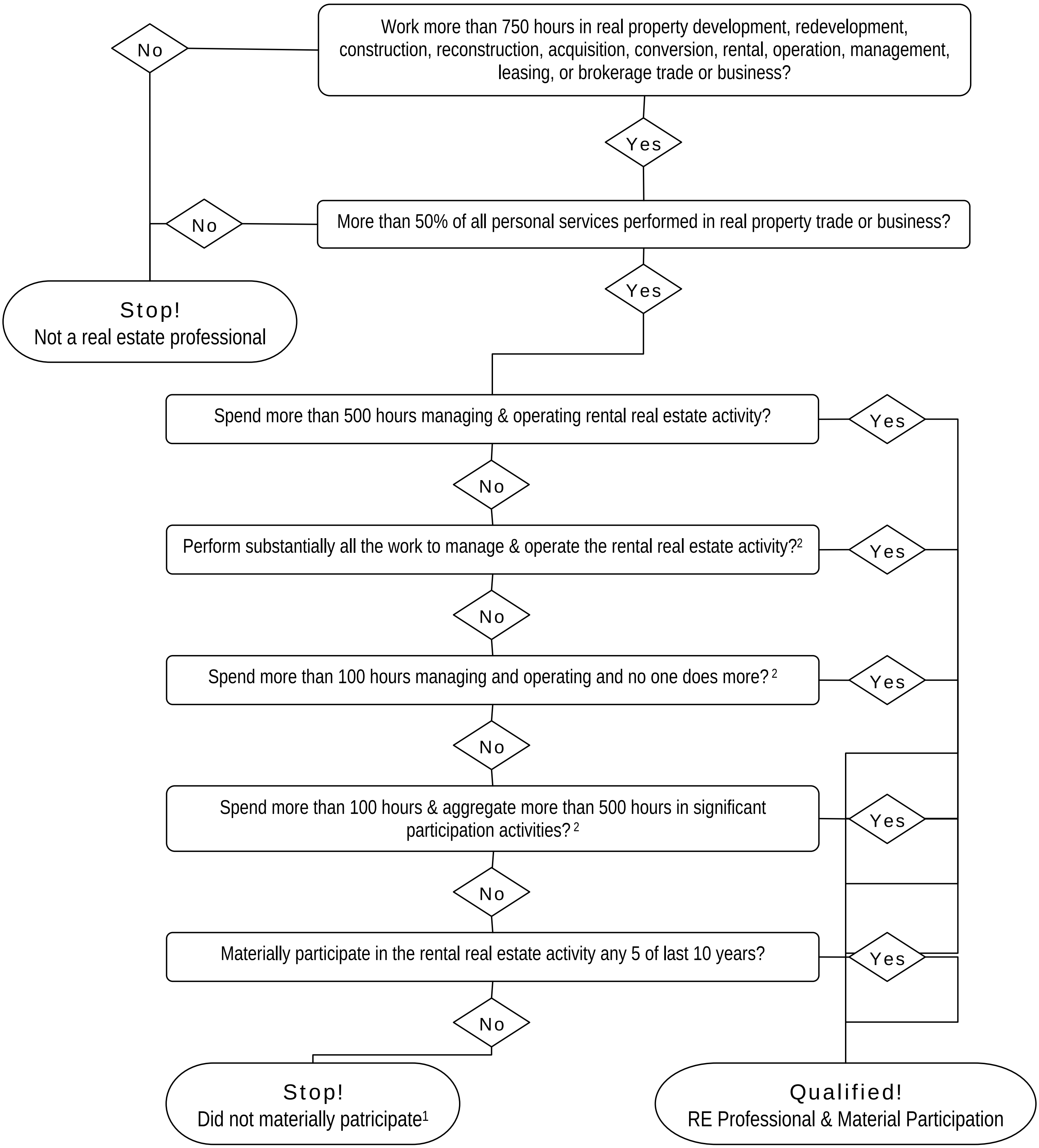
Wording for Filing a Single Rental Real Estate Activity Election LATE "FILED PURSUANT TO REV. PROC. 2011-34."
1. "In accordance with §1.469-9(g)(3), the taxpayer hereby states that he (or she) is a qualifying real estate professional under IRC §469(c)(7), and elects under IRC Sec. 469(c)(7)(A) to treat all interests in real estate as a single rental real estate activity." 2. This election is being filed late because... (e.g., the taxpayer relied on a tax professional who failed to advise him or her of the availability and benefits of this election.) 3. This election applies to year _____ (i.e., the taxable year which the taxpayer wishes to the late election to apply). 4."Under penalties of perjury I (we) declare that I (we) have examined this election, including any accompanying documents, and, to the best of my (our) knowledge and belief, the election contains all the relevant facts relating to the election, and such facts are true, correct, and complete." 5. Signed and dated by the taxpayer.

IRS will notify taxpayer if late election accepted. The IRS will notify the taxpayer after it receives the properly completed application.

The benefit. Any taxpayer receiving relief under this revenue procedure is treated as having made a timely election to treat all interests in rental real estate as a single rental real estate activity as of the taxable year for which the late election was requested.

> ***Note.*** These procedures are in lieu of a letter ruling request so user fees do not apply.

Real Estate Professional Flow Chart



[1] Two additional tests for material participation: a) the activity is a personal service activity, or b) facts and circumstances support regular, continuous & substantial participation.

[2] Limited partners may only use tests 1 and 5 above, and the personal service activity test.

Passive Trades or Businesses Subject to the 3.8% Medicare Tax

Gross income is excluded from net investment income if it is derived in the ordinary course of a trade or business unless the trade or business either is a passive activity or involves the trading in financial instruments or commodities.

The ordinary course of a trade or business exception is a two-part test.

1. First, the item must be "derived in" the "ordinary course" of a "trade or business" that is not
   - a §469 passive activity with respect to the taxpayer, or
   - trading in financial instruments or commodities.
2. Second, if the item is not derived in a passive or trading in financial instruments/commodities trade or business, then such item must also be "derived in" the "ordinary course" of such "trade or business" (§1.1411-4(b); Preamble, 5,B.ii).

§162 Trade or Business

The term "trade or business," when applied to §1411 and its regulations, is defined within the meaning of §162, the rules of which are well-established by a large body of case law and administrative guidance. §1411 and its related regulations also do not define the phrase "derived in the ordinary course," relying instead on case law and the §469 regulations (TD 9644; Preamble, 5, B, ii,a & b).

§1411 Trade or Business Activities Are Subject to 3.8% NII Tax

The trades or businesses subject to the NII tax are:

1. §469 passive activities, and
2. trading in financial instruments or commodities (as defined in §475(e)(2)).

Example. Application of the rental activity exceptions. Bonnie, a single individual, is a partner in PRS, LLC, which is engaged in an equipment leasing activity. In 2013, Bonnie's modified AGI is $300,000, all of which is derived from PRS. All of the income from PRS is derived in the ordinary course of the equipment leasing activity. Bonnie's $300,000 allocable share of income from PRS constitutes gross income from rents with an average period of customer use of the equipment is seven days or less. PRS is treated as a trade or business instead of a rental activity. PRS's activities are not passive to Bonnie as she materially participates. None of Bonnie's income from PRS, including any gain or loss from the sale of the property held in the equipment leasing activity, is subject to NII tax (§1.1411-5(b)(3), Exp 3).

Variation. Application of §469 and other gross income. Assume the same facts as the previous example except that Bonnie does not materially participate PRS's activities. Bonnie's share of PRS's income ($300,000) is NII (§1.1411-4(a)(1)(ii); §1.1411-5(b)(3), Exp 4).

Can Rental Real Estate Income Be Derived in the Ordinary Course of a Trade or Business?

Interestingly, the Preamble to the Final Regulations admits that, in certain circumstances, the rental of a single property may require "regular, continuous and substantial" involvement, resulting in the rental activity being a §162 trade or business. This admission acknowledged the holdings in Fackler v. Comm., 45 BTA 708 (1941), aff'd, 133 F.2d 509 (6th Cir. 1943); Hazard v. Comm., 7 T.C. 372 (1946); and Lagreide v. Comm., 23 T.C. 508 (1954), that the activities of a single property can rise to the level of a trade or business (TD 9644; Preamble, 5,B,ii,a).

Rental of single property unlikely to be an active trade or business. At the same time, the Preamble further noted that the rental of a single piece of property would normally not rise to the level of a trade or business in every case as a matter of law (TD 9644; Preamble, 5,B,ii,a). For example, §1.212-1(h) provides that the rental of real property is an example of a for-profit investment activity under §212, not a §162 trade or business (TD 9644, Preamble, 5,B,ii,a).

Example. Rental activity. Adam rents a commercial building to Windstorm, Inc. for $50,000. Adam is not involved in the rental activity on a regular, continuous and substantial basis. Adam's rental activity does not rise to the level of a trade or business and it is a passive activity. Because the $50,000 rental income is not derived from a trade or business, Adam must treat it as gross income from rents subject to NII (per §1.1411-4(a)(1)(I)) [§1.1411-5(b)(3), Exp 1].

Key factual elements that may be relevant when determining when a rental activity rises to the level of a trade or business, include, but are not limited to:

- the type of property (commercial or residential real property, personal property, etc.),
- the number of properties rented,
- the day-to-day involvement of the owner or its agent,
- the type of rental,
- a net lease versus a traditional lease, and
- short-term versus long-term lease (TD 9644, Preamble, 5,B,ii).

The final regulations state that bright-line definitions would be impractical and imprecise due to the large number of factual combinations that exist in determining whether a rental activity rises to the level of a §162 trade or business (TD 9644, Preamble, 5,B,ii).

> ***Preparer note:*** trades or businesses issue Form 1099-MISC, landlords don't. The IRS will closely scrutinize situations where taxpayers are inconsistent in their treatment of an activity as a trade or business. For example, if a taxpayer takes the position that a certain rental activity is a trade or business for purposes of §1411, the IRS will take into account whether the taxpayer complied with any Form 1099 trade or business information reporting requirements to help determine if the activity was a trade or business (§6041; TD 9644, Preamble, 5,B,ii,a)).

A Real Estate Professional's Rental Income May Not Be NII

If a taxpayer meets the "50%/750 hours in the real property trades or businesses" requirements to be a real estate professional, the taxpayer's interest in rental real estate is no longer considered a "per se" passive rental activity; instead the rental is treated as if a "trade or business," and the "non-rental" rental real estate activity will not be a passive activity if the taxpayer materially participates in each activity.

Relief provision for real estate professional's rental real estate. Once an individual establishes real estate professional status (e.g., contractors, real estate agents, landlords, property managers, etc.), that status only allows the taxpayer to treat rental real estate activities as nonpassive if the taxpayer satisfies at least one of the seven material participation tests (see §1.469-5T(a)). The Preamble in the Final Regulations notes that not all of the material participation tests provide conclusive evidence that a taxpayer is regularly, continuously, and substantially involved in a rental trade or business, especially when the taxpayer claims material participation by performing substantially all of the work and the total time spent on the activity is under 500 hours in the year (TD 9644, Preamble, 5,E,iii).

Example. Mark is a contractor who works full time in his contracting business. He also owns a single family residence that is rented month to month. Mark is a real estate professional because he works more than 750 hours per year and more than 50% of his time in his contracting business. Additionally, Mark is the only person that provides services for his residential rental, but he rarely spends more than 20 hours in any given year. While Mark satisfies the material participation test, it is unlikely that his rental real estate rises to the level of a trade or business. Any profit he realizes would likely be included in NII.

Real estate professional safe harbor rules. The final regulations provide a safe harbor test for real estate professionals. If a real estate professional participates in rental real estate activities:

- for more than 500 hours per year, OR
- for more than 500 hours per year in five of the last ten taxable years (one or more of which may be taxable years prior to 2013),

the rental income, and the net gain on sale associated with that activity, will be deemed to be derived in the ordinary course of a trade or business exempt from the NII tax (§1.1411-4(g)(7)(i)(A) & (B); §1411(c)(1)(A)(iii); TD 9644, Preamble, 5,E,iii).

> ***Example.*** Sharon owns a shopping center. She spends 1,000 hours a year managing the property. Because Sharon spends more than 750 hours a year and spends more than 50% of her personal service hours in a qualified real estate activity, she is a real estate professional (§469(c)(7)). In addition, as she spends more than 500 hours materially participating in her rental activity, any income Sharon receives from the shopping center, including any gain realized upon its eventual sale, is not NII (per §1.1411-4(g)(7)).

Real estate professionals unable to meet the 500 hour safe harbor may still avoid NII tax. Real estate professionals with substantial rental activities may derive such rental income in the ordinary course of a trade or business, even though they fail to satisfy the safe harbor 500 hour requirement. All facts and circumstances must be analyzed to determine if a real estate rental activity rises to the level of a trade or business (§1.1411-4(g)(7)(iii); T. D. 9644, Preamble, 5,E,iii).

> *Planning point.* The election to treat all rental real estate as a single activity is permitted for NII purposes (under §1.469-9(g)). However, any rental real estate grouped with a trade or business (under §1.469-4(d)(1)(i)(A) or (d)(1)(i)(c)) is treated as a trade or business, not a rental real estate activity (§1.1411-4(g)(7)(ii)(B)).

Self-Charged Rental Income Received from a Taxpayer's Active Trade or Business Is Not NII

Rents received by a landlord from a business in which he or she materially participates must be recharacterized as income not from a passive activity (§1.469-2(f)(6)). This is commonly called the "self-rental" recharacterization rule.

Self-Charged Interest Received From the Taxpayer's Active Trade or Business is Not NII. Gross income from interest that is received by the taxpayer from a nonpassive activity of such taxpayer (self-charged interest), is treated as derived in the ordinary course of a trade or business and is not NII. The amount of interest income that is excluded from NII is limited to the amount that would have been considered passive activity income if the payor was a passive activity of the taxpayer. This special rule does not apply when the interest deduction is taken into account in determining the 2.90% HI tax, that is SE tax above the FICA wage base (§1.1411-4(g)(5); TD 9644, Preamble, 5,E,i; §1401(b)).

Installment Sales

When a taxpayer sells property and some or all of the payments for sale are to be paid in the future, the transaction generally is called an installment sale. When installment reporting of the gain is available, it is an important financing and tax planning option for both the seller and the buyer.

Why use the installment method? To spread the taxable gain over multiple years. A taxpayer who sells property on the installment plan is allowed to have a pro-rata portion of the total gain taxed as each installment is actually received. Thus, the seller, instead of paying the whole tax in the year of the sale, may spread the tax on the gain over the period during which the installments are received.

Benefits of an Installment Sale:

- Taking payments over time may facilitate the sale and improve the price.
- Deferring long-term capital gain may provide the opportunity to offset it with a loss realized in the future.
- Pushing gain into a future year when the current year has a NOL may allow more loss to be carried back against a previous year's ordinary income.
- Deferring gain may place the income into a lower tax-bracket year.

Example. Ralph and Cay, residents of California, sold appreciated property in 2013 with an adjusted basis of $50,000 at a sale price of $150,000. They received $75,000 on the close of the sale and will receive the remaining $75,000 one year from the date of the close. They surrendered title on the closing date and received a note, payable with interest, for the remaining $75,000.

	Without Installment Sale		**With Installment Sale**	
	2013	**2014**	**2013**	**2014**
Other Ordinary Income	50,000	50,000	50,000	50,000
Interest	5,000	5,000	5,000	5,000
Capital Gains	100,000	0	50,000	50,000
Adjusted Gross Income	155,000	55,000	105,000	105,000
Itemized Deductions				
Taxes	8,601	805	6,236	5,933
Standard Deduction	12,200	12,400	12,200	12,400
Personal Exemptions	7,800	7,900	7,800	7,900
Taxable Income	135,000	34,700	85,000	84,700
Federal Regular Tax	**13,736**	**4,298**	**6,236**	**5,933**
State Regular Tax	**8,601**	**805**	**3,982**	**3,982**
2-Year Total Taxes	**27,440**		**20,133**	

Electing Out of Installment Method

A taxpayer who reports an amount realized that equals the selling price and includes the full amount of the gain of any installment obligation in connection with the sale is considered to have made an effective election that the installment sales provisions of §453 are not applicable (§15A.453-1T(d)(3)(i)). This election generally must be made on or before the due date (including extensions) for filing the taxpayer's return for the year of sale (§453(d)(1); §15A.453-1(d)(3)).

Why Accelerate Reporting Gain by Electing out of the Installment Reporting Method?
1. The seller may have another capital loss that can absorb the capital gain. 2. The seller may have a net operating loss. 3. The seller may have suspended losses that will offset a passive gain 4. The seller's future tax rates are anticipated to increase, either by congressional action or if the seller anticipates escalating into a higher tax bracket. 5. The taxpayer only wishes to increase AGI for the year of sale, not for future years in order to avoid additional taxable social security, Medicare premium increases, loss of itemized deductions, and many other items impacted by an increased AGI.

Late Elections

A late election normally is not permitted. Unless the IRS determines that the taxpayer has a good cause for failing to make the election on time, late elections are not allowed (§15A.453-1(d)(3)). In LTR 200404015, the IRS granted a cash-method calendar-year taxpayer to make a late election with respect to reporting gain from a sales contract. See also PLR 8832002 where the taxpayer blamed the tax preparer for making the wrong decision.

A change of mind after election also normally is not permitted. A valid election out of the installment method cannot be revoked without IRS permission (§15A.453-1(d)(4)). Yet, in LTR 200404035, the IRS granted a cash basis partnership to revoke the election out of the installment method for a sale of real estate as the accounting firm that prepared the partnership return inadvertently reported all the gain. The partnership convinced the IRS that there was no intention on its part to elect out of the installment method and that the request for a change was not due to hindsight.

> ***Planning Point.*** An election out can be especially damaging when, in a subsequent audit, the IRS disallows expenses or increases income that the taxpayer originally did not take into account when reporting all the gain instead of using the installment method! The IRS says, "Tough bounce"–you should have done it correctly in the first place (as if they knew)!

Foreclosure on Property Sold on Installment

Taxpayers forced to repossess property are often surprised to learn that once the repossession is complete, they will have tax to pay on the transaction, regardless of the fact that the whole reason for the repossession was that they were not receiving any payments. The law provides that in the event of a foreclosure on property sold on installment, the taxpayer must recognize gain in the year of foreclosure to the lesser of the total principal payments received or the total original gain less any gain previously reported.

Example. Jerry, a retired doctor, bought vacant land in 1996 for $60,000. In 2007, Jerry sold the property to Jake for $200,000. Jake made a $40,000 down payment and agreed to make monthly interest only payments for five years, at which time the balance of the note would be due and payable. Jake quit making payments in 2009 and Jerry foreclosed and took the property back in March of 2010.

When the original sale took place, Jerry elected to use the installment method for reporting the income from the sale of the land. Accordingly, he included $28,000 ($140,000 gain/$200,000 contact price multiplied times the $40,000 down payment) of capital gain income on his 2007 tax return. Now, after going through the hassle of foreclosing, Jerry finds out that he must pay tax on an additional $12,000 of income in 2010 (the remainder of the cash down payment). Not a lot of fun to explain this one!

Like-Kind Exchanges

The exchange of property for the same kind of property is the most common type of nontaxable exchange. To be a like-kind exchange under IRC §1031, the property traded and the property received must be both of the following:

- Qualifying property
- Like-kind property

Additional requirements apply to exchanges in which the property received is not received immediately upon the transfer of the property given up (a *deferred* exchange).

If a like-kind exchange involves the receipt of money or unlike property or the assumption of liabilities (commonly referred to as "*boot*"), the taxpayer may have to recognize gain.

The like-kind exchange rules also apply to property exchanges that involve three- and four-party transactions. Any part of these multiple-party transactions can qualify as a like-kind exchange if it meets all the requirements described in §1031 (Rev. Rul. 75-292, 1975-2 CB 333).

§1031 – The Basics

IRC §1031 and the related regulations lay out the following rules related to exchanges:

1. No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like-kind which is to be held either for productive use in a trade or business or for investment (§1031(a)(1)).
2. To the extent of cash or other "boot" (not like kind property) received, gain is recognized (§1031(b)).
3. Net relief of the transferor taxpayer's mortgage debt is considered boot received (§1.1031(b)-1).
4. The amount of boot received is decreased by the taxpayer's exchange expenses (§1.1031-(d)-2, Ex. (2)).

Gain Recognized – a Simple Calculation

Gain to be recognized on an exchange is the sum of:

Money or Other Boot Received	________________
Plus: Net Mortgage Relief	________________
Reduced by Exchange Expenses	________________
Gain Recognized	________________

Note: Money or other boot given can offset mortgage relief. However, an increase in mortgage does not offset cash or other boot received.

Karen's 3 Simple Rules

- Always trade even or up (FMV)
- Never, never, never receive any cash
- Always end up with at least as much or more mortgage as you had to start

Why Do a 1031 Exchange?

The most obvious reason for performing a tax-deferred exchange is to defer the payment of tax. §1031 allows a taxpayer who properly completes an exchange of qualifying, like-kind property to avoid recognition of the gain associated with the relinquished property and thus avoid the tax on that gain. But is tax saving the only reason to do an exchange?

By exchanging, an investor not only saves taxes but can use the increase of net worth, or "equity," to acquire additional real estate. Coupled with the magic of leverage, this can create dramatic results.

Example. Karen owns a single-family rental house as follows:

Adjusted basis	$100,000
Current mortgage	$50,000
Fair market value	$250,000

If Karen sells the house, she recognizes $150,000 gain. Assuming a combined federal and state effective rate of 30%, she'll owe taxes in the amount of $45,000.

That would allow Karen to invest $155,000 (250,000 – 50,000 mortgage – 45,000 taxes) in a new property. Assuming she qualifies for a loan with 30% downpayment, she can acquire a property valued at $517,000 (155,000 ÷ 30%).

If Karen performs a §1031 exchange, she avoids gain recognition, avoids tax and has $200,000 to invest in a property worth $667,000.

Why Not Do a §1031 Exchange?

Generally, real estate investors wish to avoid an exchange in the following situations:

1. **When property could be sold for a loss.** This is because the loss on an exchange is not currently deductible, and the loss on a sale may be fully currently deductible as a §1231 ordinary business loss.

2. **When a taxable gain can be offset with other currently deductible losses that result in minimal tax due**. Exchanges generally cost more money to complete than sales transactions and, thus, current losses are normally more valuable than deferred losses.

3. **When liquidity is required.** This usually occurs at the time of retirement or for medical or other emergencies.

4. **When investors do not want any other property.** An example is when the individual wishes to discontinue managing the real estate and is tired of being a landlord.

Qualifying Property

In a like-kind exchange, both the property given up (the relinquished property) and the property received (the replacement property) ***must be held by for investment or for productive use in a trade or business*** (§1031(a)(1)). Machinery, buildings, land, trucks, and rental houses are examples of property that may qualify.

The rules for like-kind exchanges ***do not apply*** to exchanges of the following property:

- Property used for personal purposes, such as a home and a family car.
- Stock in trade or other property held primarily for sale, such as inventories, raw materials, and real estate held by dealers.
- Stocks, bonds, notes, or other securities or evidences of indebtedness, such as accounts receivable.
- Partnership interests.

- Certificates of trust or beneficial interest.
- Choses in action, such as a lawsuit in which taxpayer is the plaintiff.
- Certain tax-exempt use property subject to a lease.

An exchange of the assets of a business for the assets of a similar business cannot be treated as an exchange of one property for another property. Whether the taxpayer engaged in a like-kind exchange depends on an analysis of each asset involved in the exchange. However, see Multiple Property Exchanges, later.

Like-Kind Property

There must be an exchange of like-kind property. Like-kind properties are properties of the same nature or character, even if they differ in grade or quality(§1.1031(a)-1(b)). The exchange of real estate for real estate and the exchange of personal property for similar personal property are exchanges of like-kind property. For example, the trade of land improved with an apartment house for land improved with a store building, or a panel truck for a pickup truck, are both like-kind exchanges.

An exchange of personal property for real property does not qualify as a like-kind exchange. For example, an exchange of a piece of machinery for a store building does not qualify. Also, the exchange of livestock of different sexes does not qualify.

Real Property

The Internal Revenue Service is quite liberal in interpreting that all real estate is similar in nature or character and does not have a different grade or quality. The fact that any real estate is improved or unimproved is not material. Also, unproductive real estate held for future use or appreciation in value is held for investment (§1.1031(a)-1(b)).

> ***Tax Tip.*** Any business property for investment property qualifies. Therefore, any mixture of office buildings, apartment buildings, factory buildings, shopping centers, stores, hotels, motels, farms, ranches and parking lots is permitted.

Fee simple transfers. Exchanging fee simple ownership in real estate is virtually always of like-kind to other fee interests in realty. Fee simple property may even be exchanged for leases in excess of 30 years (§1.1031(a)-1(b),(c)).

Mineral interests. Mineral and nonmineral real estate interests may be exchanged on a like-kind basis provided that the mineral interests are considered real property under state law and are of substantial equality with respect to the character and nature of title as the nonmineral property given. For example, oil and gas royalty rights are of like-kind to ranch properties (Rev. Rul. 55-749, 1955-2 CB 95; LTR 7935126).

Leasehold. Thirty-year, or longer, leaseholds and real property (e.g., land or building) are considered to be like-kind (§1.1031(a)-1(c)). Optional renewal periods are included when calculating the 30 years (Rev. Rul. 78-72. 1978-1 CB 258). Therefore, less than-30 year leaseholds are not of like-kind to a fee ownership in real estate (***Capri, Inc***., 65 TC 162

(1975)). Interestingly, leaseholds with a remaining duration of less than 30 years are of like-kind to each other (Rev. Rul. 76-301, 1976-2 CB 241).

Sale coupled with a leaseback. A sale of property coupled with the seller leasing the property back for 30 years or longer is considered an exchange of like-kind property, according to the IRS (§1.1031(a)-1(c)(2)). If the property being disposed of would have created a loss upon sale, this could be disastrous. The courts disagree with this regulation when both the sales price and the rent charged were fair market value (***Jordan Marsh Co. v. Comm***., 269 F2d 452 (2d Cir. 1959), nonacq.; ***Lesslie Co. v. Comm***., 539 F2d 943 (3rd Cir. 1976), nonacq., 1978-1 CB 3). Losses have been allowed where the leaseback was for less than a 30-year term, as less-than-30-year leaseholds are not of like-kind to fee estates (Rev. Rul. 78-72, 1978-1 CB 258; ***Standard Envelope Manufacturing Co***., 15 TC 41 (1950), acq., 1950-2 CB 4).

Development Rights. In a private letter ruling, the taxpayer proposed to exchange development rights for a fee interest in real estate, a leasehold interest in real estate of 30 years or more remaining, and land use rights for hotel units. The new rights for hotel units were to be applied to property the taxpayer already owned. The development rights were in perpetuity and directly related and requisite to the taxpayer's interest, use and enjoyment of the underlying land. The development rights were also interests in real property under state law. In effect, the taxpayer was exchanging one set of development rights (pertaining to residential density) for other development rights (pertaining to hotel development). Some of the development rights were also exchanged for another fee interest in land, and another long-term leasehold interest in additional real property.

The IRS ruled that the development rights to be transferred by the taxpayer as relinquished property were of like kind to a fee interest in real estate, a leasehold interest in real estate with 30 years or more remaining at the time of the exchange and land use rights for hotel units (which the taxpayer received if the development rights it transfers are for more than the residential units) (LTR 200901020).

Other examples of "like-kind" real property:

1. Commercial building for lots (***Burkhard Inv. Co. v. U.S***., 100 F.2d 642 (9th Cir 1938))
2. City real estate for a farm or ranch (§1.1031(a)-1(c))
3. Developed property for undeveloped property (§1.1031(a)-1(c))
4. Land subject to a 99-year condominium lease (***Carl E. Koch,*** 71 TC 54, 1978, acq.)
5. Improved real property for unimproved real property regardless of the locations (§1.1031(a)-1(c)), with the exception of foreign real estate (§1031(h))
6. Timberland for timberland (Rev. Rul. 72-515; Rev. Rul. 76-253)
7. A remainder interest in farmland for a remainder interest in other farmland (Rev. Rul. 78-4)
8. Perpetual water rights for a fee interest in land (Rev. Rul. 55-749; LTR 200404044)
9. Producing oil leases for a ranch (Rev. Rul. 68-331)

10. An easement on a farm for an unencumbered fee simple interest in another farm (PLR 9215049)
11. A conservation easement for a cattle ranch (LTR 200203033; 200203042; 200201007)
12. A cooperative leasehold interest for a condominium fee simple interest (LTR 200631012; LTR 200137032).

Foreign real property exchanges. Real property located in the United States and real property located outside the United States are not considered like-kind property under the like-kind exchange rules (§1031(h)). In an exchange of foreign real property for property located in the United States, the gain or loss on the exchange is recognized. Foreign real property is real property not located in a state or the District of Columbia.

This foreign real property exchange rule does not apply to the replacement of condemned real property. Foreign and U.S. real property can still be considered like-kind property under the rules for replacing condemned property to postpone reporting gain on the condemnation.

Tenant in common investors. A tenant in common (TIC) interest is generally not a partnership interest but an undivided fractional interest in the real property. Thus, it can be treated as like-kind for the exchange rules. Rev Proc. 2002-22 clarifies the parameters necessary for a TIC interest to be treated as an interest in real estate (like-kind property) rather than an interest in a partnership (unlike property). Among other rules, (1) the TIC owner must hold title to the property, (2) there can be no more than 35 co-owners, (3) the group cannot file a partnership or corporation tax return or conduct business under a common name, and (4) co-owners must retain the right to hire or fire managers, sell the property or refinance the property.

Tenants in common, however, may be partners in a partnership if they actively carry on a trade, business, financial operation or venture and divide the profits from the enterprise. For example, a partnership exists if co-owners of an apartment building lease space and in addition provide services to the occupants, either directly or through an agent (§1.761-1(a)).

Because a partnership interest in rental real estate cannot be traded tax-free under §1031, but a co-ownership interest, such as tenancy-in-common, of the same rental real estate can avail itself of the §1031 benefits, taxpayers have inundated the IRS with requests for ruling on the taxpayer's ownership interest. The central characteristic of a tenancy in common, one of the traditional concurrent estates in land, is that each owner is deemed to own individually a physically undivided part of the entire parcel of property. Each tenant in common is entitled to share with the other tenants the possession of the whole parcel and has the associated rights to a proportionate share of rents or profits from the property, to transfer the interest, and to demand a partition of the property.

Personal Property

Depreciable tangible personal property can be either like-kind or like-class to qualify for nonrecognition treatment. Like-class properties are depreciable tangible personal properties within the same General Asset Class or Product Class. Property classified in any General Asset Class may not be classified within a Product Class.

General Asset Classes. General Asset Classes describe the types of property frequently used in many businesses. They include the following property:

1. Office furniture, fixtures, and equipment (asset class 00.11).
2. Information systems, such as computers and peripheral equipment (asset class 00.12).
3. Data handling equipment except computers (asset class 00.13).
4. Airplanes (airframes and engines), except planes used in commercial or contract carrying of passengers or freight, and all helicopters (airframes and engines) (asset class 00.21).
5. Automobiles and taxis (asset class 00.22).
6. Buses (asset class 00.23).
7. Light general purpose trucks (asset class 00.241).
8. Heavy general purpose trucks (asset class 00.242).
9. Railroad cars and locomotives except those owned by railroad transportation companies (asset class 00.25).
10. Tractor units for use over the road (asset class 00.26).
11. Trailers and trailer-mounted containers (asset class 00.27).
12. Vessels, barges, tugs, and similar water-transportation equipment, except those used in marine construction (asset class 00.28).
13. Industrial steam and electric generation or distribution systems (asset class 00.4).

Product Classes. Product Classes include property listed in a 6-digit product class (except any ending in 9) in sectors 31 through 33 of the North American Industry Classification System (NAICS) of the Executive Office of the President, Office of Management and Budget, United States, 2007 (NAICS Manual). It can be accessed at:

http://www.census.gov/naics

Example. Sharon transfers a personal computer used in her business for a printer to be used in her business. The properties exchanged are within the same General Asset Class and are of a like class.

Example 2. Vern transfers a grader to Ron in exchange for a scraper. Both are used in a business. Neither property is within any of the General Asset Classes. Both properties, however, are within the same Product Class and are of a like class.

Intangible Personal Property and Nondepreciable Personal Property

In an exchange of intangible personal property (such as a patent or a copyright) or nondepreciable personal property (such as property with a useful life that does not exceed the year it was placed in service), no gain or loss is recognized on the exchange only if the exchanged properties are of like-kind. (There are no like classes for these properties.) Whether intangible personal property, such as a patent or copyright, is of a like-kind to other intangible personal property generally depends on the nature or character of the rights involved. It also depends on the nature or character of the underlying property to which those rights relate.

> ***Example.*** Stephen King exchanges a copyright on a novel for a copyright on a different novel. That can qualify as a like-kind exchange.
>
> However, if Mr. King exchanges a copyright on a novel with Paul McCartney for a copyright on a song is not a like-kind exchange.

Goodwill and Going Concern

The exchange of the goodwill or going concern value of a business for the goodwill or going concern value of another business is not a like-kind exchange.

Trademarks, Trade Names, Mastheads, and Customer-based Intangibles That Can Be Separately Described and Valued Apart from Goodwill

On January 13, 2006, the Office of Associate Chief Counsel (Income Tax & Accounting) issued technical advice (TAM 200602034) concluding that the registered trademarks and trade names of a business entity could not be of like kind to the trademarks and trade names of another business entity because they were "closely related to (if not a part of) the goodwill or going concern value of a business."

Upon further consideration, the Office of Associate Chief Counsel (Income Tax & Accounting) has concluded in CCA 200911006 that the Tax Court's analysis of Newark Morning Ledger Co. (***Newark Morning Ledger Co. v. U.S.*** ,(507 U.S. 546 (1993) (93-1 USTC ¶50,228), which holds that an intangible asset is not goodwill for purposes of the depreciation rules if it can be separately described and valued apart from goodwill, applies in determining whether intangibles constitute goodwill or going concern value within the meaning of §1.1031(a)-2(c)(2). Accordingly, intangibles such as trademarks, trade names, mastheads, and customer-based intangibles that can be separately described and valued apart from goodwill qualify as like-kind property under §1031. In the opinion of the Office of Associate Chief Counsel, except in rare and unusual situations, intangibles such as trademarks, trade names, mastheads, and customer-based intangibles can be separately described and valued apart from goodwill. Of course, to qualify as like-kind property under §1031, the property must satisfy all other requirements of §1031 including the nature and character rules of §1.1031(a)-2(c)(1). Accordingly, the Service should not follow the position in TAM 200602034.

Foreign Personal Property Exchanges

Personal property used predominantly in the United States and personal property used predominantly outside the United States are not like-kind property under the like-kind exchange rules. In an exchange of property used predominantly in the United States for property used predominantly outside the United States, the gain or loss on the exchange is recognized.

Multiple Asset Exchanges

When a taxpayer exchanges one business for a similar business, is the exchanged property the business for the other business? Can we exchange a Wendy's for a McDonald's, or a farm for a farm? According to the IRS, we cannot do a business-for-business exchange. It is an exchange of the separate assets of the businesses.

> ***Example.*** Eric exchanges his laundry business, comprising a building and seven washer and dryer units (fair market value of $1,000 per unit), to Carolyn for her laundry business, comprising a building, five washer and dryer units (fair market value of $1,000 per unit), and an old pickup truck. Can Eric consider the exchange to be entirely tax-free? No.

As a general rule, real property may continue to be exchanged as one group, but personal property must be segregated into specific like-kind groups (§1.1031 (j)-1(a)(1); (§1.1031(j)-1(b)(2)(i); Rev. Rul. 89-121; Rev. Rul. 72-151). The separation of the properties transferred and the properties received into exchange groups involves matching up properties of a like-kind or like-class to the smallest extent possible (§1.1031(j)-1(a)(2)). For example:

1. Personal properties are accumulated into separate exchange groups of the same General Asset Class or within the same Product Class (as defined in §1.1031(a)-2(b)).
2. All real properties belong to one exchange group as they are of a like kind.
3. Not-like-kind property. If property exists that cannot be matched up like-kind (or is unqualified property) it must be placed in the residual group.

How do the §1031 exchange rules apply to these exchange groups? The §1031 exchange rules apply separately to each exchange group to determine the amount of gain recognized in the exchange (§1.1031(j)-1(a)(2)(i)).

> ***Example (continued).*** Eric and Carolyn have a tax-deferred like-kind exchange only to the extent of the first exchange group, consisting of the five washers and dryers being traded for five washers and dryers (Product Class 3633). But both have taxable boot (a non-like-kind exchange) to the extent of the second exchange group - that is: Eric's trade of two washers and dryers (Product Class 3633) for Carolyn's pickup truck (ADR 00.22).

Example. Paul owns a ranch comprised of three separately purchased properties that are exchanged (one deed) with Susie for 20 commercial lots (again via one deed). Even though this exchange involves 23 separate properties, it is one separate exchange group for §1031 purposes, and the §1031 exchange rules apply to the group, not to each separate property.

The Structure of §1031 Exchanges

What normally is found in exchange transactions is one seller who needs cash (and, therefore, is willing to pay tax on any gain), one buyer who wishes to purchase property – with cash, and our client, an investor, who wants a (tax-free) exchange, not cash ... with none of the parties directly wanting what the other is offering.

Strange as it may sound, a multiparty exchange often involves only one party interested in an exchange, coupled with one buyer and one seller. Properly structured, the objectives of all parties can be accomplished in a multiparty or a three-legged exchange. The taxpayer, of course, is seeking to avoid recognition of gain in the disposition of the appreciated property.

An exchange may be taxable to one party and tax-free to the other; it need not be tax-free to both parties for §1031 to apply (Rev. Rul. 75-292, 1975-2 CB 333).

Simultaneous vs. Deferred Exchanges

As the name implies, a "simultaneous" exchange is one in which the taxpayer transfers a property (or properties) directly in exchange for another property (or properties). A simultaneous exchange can be a two-, three-, or multi-party exchange. A simultaneous exchange can also use the services of a neutral accommodator, but often does not.

The Two-Party Exchange

The two-party exchange is the simplest to understand, but also the most difficult exchange to accomplish, because not only must both parties be willing to trade properties but the properties and equities must be of approximately the same value. In reality, this seldom happens.

Example. Karen owns a single family residential rental in Palo Alto, CA with $1 million equity. Sharon owns a multi-family apartment building in Dubuque, IA also with $1 million equity. They agree to exchange properties. The transaction is tax-deferred for both Karen and Sharon.

The Three-Party Exchange

What happens if one party in an exchange does not want any property owned by the other party but rather wants a third party's property? Exchanges involving three parties are about as common as two-party exchanges are rare, and it may turn a taxable sale into a nontaxable exchange.

In most cases, the exchanger may directly locate, negotiate, and assist in the acquisition of the property for which he or she wishes to exchange (***Rutland v. Comm.***, 36 TCM 40 (1977); Rev. Rul 77-297, 1977-2 CB 304; PLR 8110028).

Caution! The exchanger should avoid executing any direct options and, in particular, purchase contracts directly with the seller. As discussed later, the property must be acquired through an exchange, not a purchase.

May the Internal Revenue Service pierce a multiparty or three-legged exchange on the grounds that it is being done for tax purposes only and therefore is a sham? No, according to ***Alderson v. Comm.***, 317 F2d 790 (9th Cir. 1963) and many other subsequent cases; it is form over substance. The IRS also recognizes multiparty exchanges (Rev. Rul. 77-297, 1977-2 CB 304).

The Starker III case (***T.J. Starker v. U.S.***, 602 F.2d 1341 (CA-9, 79-2 USTC ¶9451)) was considered an exchange because:

1. **Exchange, not sale, planned.** The taxpayer claimed that he intended from the outset of the transaction to receive nothing but like-kind property.
2. **Integrated plan exists.** All the recorded evidence indicated an exchange occurred.
3. **No actual or constructive receipt of cash.** The taxpayer never handled any cash in the course of the transaction.

Exchange Property, Not Cash

Exchangers will recognize gain when the courts determine they actually "sold" property and then reinvested the money by purchasing like-kind property, even when there existed an intent for a tax-free exchange (***Carlton v. U.S***., 385 F2d 238, (5th Cir. 1967)). The opposite is also true.

Contractual Interdependence

The closing of each escrow (leg of the exchange) should be contingent on the closing of all escrows. However, contractual or mutual interdependence of the separate transactions in a multiparty exchange is not necessarily a critical factor so long as the exchanger never has actual or effective control of the cash (compare ***Barker v. Comm***., 74 TC 555 (1980), with ***Brauer v. Comm***., 74 TC 1134 (1980) and ***Biggs v. Comm***., 69 TC 905 (1978), aff'd 632 F2d 1171 (5th Cir. 1981)).

Exchange, Not Sale, Must Be Planned

The escrows should be part of an integrated plan showing that the exchanger wishes to effect a §1031 exchange. This is evidenced by showing that an integrated plan for a like-kind exchange is conceived and implemented; the exchanger's actions are consistent with exchanging; the conditions required to effect that intent are met; the contracts providing for the necessary series of transfers are interdependent; and no cash proceeds from the sale of the original property are actually or constructively received by the exchanger (***Garcia v Comm***., 80 TC 491 (1983), acq. 1984-1 CB 1).

Exchanger Must Not Actually or Constructively Receive Cash

As a general rule, the problem with not using an accommodator is that a transaction will constitute a taxable sale and not an exchange if the exchanger actually or constructively receives money or other property (boot) for the relinquished property before he or she actually receives the like-kind replacement property. The result is that the exchange becomes a taxable sale and subsequent repurchase, not an exchange, even though the taxpayer desired an exchange from the inception.

Actual receipt. The taxpayer is in actual receipt of money or property at the time the taxpayer actually receives such money or property, or receives the economic benefit of such money or property (e.g., pledging the property as security for a loan) (§1.1031(k)-1(f)(2)).

Constructive receipt. The taxpayer is in constructive receipt of money or property at the time such money or property is credited to the taxpayer’s account, set apart for the taxpayer, or otherwise made available so that the taxpayer may draw upon it at any time or so that the taxpayer can draw upon it if notice of intention to withdraw is given (§1.1031(k)-1(f)(2)).

Example. Vern transfers a $100,000 fair market value (FMV) rental property to Ron in a deferred exchange on May 17, 2009. On or before November 13, 2009 (the end of the exchange period), Ron is required to purchase and transfer the property identified by Vern. At any time after May 17, 2009, and before Ron has purchased the replacement property, Vern has the right, upon notice, to demand that Ron pay $100,000 cash in lieu of acquiring the property.

Result: No §1031(a) exchange available. It is a taxable sale followed by a subsequent repurchase because Vern has the unrestricted right to demand cash as of May 17, 2009. This is constructive receipt as of that date (§1.1031(k)-1(f)(3)).

Changing to an Exchange after Signing an Offer-To-Sell (i.e., in Midstream)

The IRS allows the taxpayer to change a sale to an exchange at any time prior to closing (see the deferred exchange regulations, §1.1031(k)-1(a)). The Tax Court looks at the form of the transaction over its substance (***Leslie Q. Coupe***, 52 TC 394 (1969)). As long as an exchange is “intended,” most court decisions find the details of the transaction are insignificant (***Rutland v. Comm***., 36 TCM 40 (1977); ***Biggs v. Comm***., 632 F 2d 1171

(5th Cir. 1981), aff'g 69 TC 905 (1978); ***Garcia v. Comm***., 80 TC 491 (1983), acq. 1984-1 CB 1).

The qualified exchange may even contain the contingency that the transaction may, at the option of the exchanger, convert back to a cash sale (***Antone Borchard***, TCM 1965-297), or, alternatively, if the buyer cannot find suitable property, the exchanger may demand cash (***Barker v. Comm***., 74 TC 555 (1980)).

Four-Party (Neutral Accommodator) Exchange

Sometimes buyers of real estate want only to pay their money and be done with the deal. They have little interest in, or are unable to fund, the purchase of "replacement property" for the exchanger. The seller may also be uncomfortable in being the middleman. What happens if a buyer or a seller simply doesn't want to be bothered with this complication and starts looking for other property? How can the exchanger keep the deal together?

When either the buyer or the seller is unwilling to act as the accommodator, a fourth-party escrow agent may act as a go-between to help facilitate the exchange (***Earlene T. Parker***, 74 TC 555 (1980)). In such cases, "intermediaries" and "accommodators" have sprung up to facilitate regular exchanges – and now deferred exchanges. This is the same as a three-party exchange, except that a fourth-party accommodator assists all parties to effect the exchange.

The Mechanics of an Accommodator-Assisted Exchange

With the IRS blessing of direct deeding, the exchanger may deed the property directly to the buyer. The buyer then transfers the money to the accommodator (not to the exchanger). Finally, the accommodator pays for the seller's property, and the seller is permitted to deed the property directly to the exchanger. Before these IRS pronouncements, three or more separate escrows were required with the exchanger receiving each deed and subsequently granting each deed (Rev. Rul. 90-34, I.R.B. 1990-16; §1.1031(k)-1(g)(4)(iv)).

Does the use of a fourth-party accommodator create constructive receipt via the principal-agent relationship? No. The use of a third-party or fourth-party accommodator may actually prevent actual or constructive receipt. According to the Tax Courts, followed belatedly by the IRS, in the case of simultaneous transfers of like-kind properties involving a qualified accommodator, the qualified accommodator is not considered the agent of the taxpayer for purposes of the like-kind exchange rules. In such cases, the transfer and receipt of property by the taxpayer is treated as an exchange (***Brauer v. Comm***., 74 TC 1134 (1980); §1.1031(b)-(2)).

Using a qualified accommodator's participation. This practice prevents the taxpayer from constructively receiving the purchase money. The IRS has announced that both simultaneous and deferred exchanges are permitted (but not required) to be facilitated by the use of a qualified intermediary if the exchanger's rights to receive the money or other property held by the accommodator are substantially limited or restricted. In this case the qualified accommodator is not considered the agent of the taxpayer (an agent is normally a disqualified person). The accommodator may actually purchase the property (even from money advanced directly by the exchanger) and then effect an exchange or simply assign the contractual right to purchase the property desired (see subsequent discussion on direct deeding) (§1.1031(k)-1(g)(4)(i)&(vi)).

Who Can Be a Fourth-Party Accommodator?

In numerous court cases, title companies, real estate agents and attorneys have all qualified as independent accommodators. In addition, the IRS has created a "safe harbor" qualified accommodator discussed more fully in this section.

A qualified accommodator is one

1. who is not the taxpayer, related to the taxpayer or an agent of the taxpayer in the past two years (as discussed below) and
2. who acts to facilitate a deferred exchange by entering into a written agreement (called the exchange agreement) and, as required by the exchange agreement, acquires the relinquished property from the taxpayer, transfers the relinquished property, acquires the replacement property, and transfers the replacement property to the taxpayer (§1.1031(k)-1(g)(4)(iii)).

No agent of the taxpayer – within the last two years. Anyone who is the agent of the taxpayer at the time of the transaction is disqualified. For this purpose, a person who has acted as the taxpayer's employee, attorney, accountant, investment banker or broker, or real estate agent or broker within the two-year period ending on the date of the transfer of the first of the relinquished properties is treated as an agent of the taxpayer at the time of the transaction.

Real estate agents, escrow agents and title companies qualify. The performance of the following services will not be taken into account in determining who is an agent:

1. **Putting together an exchange.** Services for the taxpayer with respect to exchanges of property intended to qualify for nonrecognition of gain or loss under §1031
2. **Routine financial, title insurance, escrow or trust services** for the taxpayer by a financial institution, title insurance company or escrow company [§1.1031(k)-1(k)(2)]

> ***Example Taxpayer's Accountant.*** Cathy's Tax Service is Bill's accountant and has rendered accounting services to Bill within the two-year period ending on May 17, 2010, in addition to counseling him about the exchange of this property to qualify for nonrecognition of gain or loss under §1031.
>
> Cathy's Tax Service is a disqualified person because it has acted as Bill's accountant within the two-year period ending on May 17, 2010.

If Cathy's Tax Service had not acted as Bill's accountant within the two-year period ending on May 17, 2010, or if it had acted as Bill's accountant within that period only with respect to exchanges intended to qualify for nonrecognition of gain or loss under §1031, Cathy's Tax Service would not have been a disqualified person (§1.1031(k)-1(k)(5)(Example 1)).

Example Escrow Company. Cathy's Exchange Service, which is engaged in the trade or business of acting as an accommodator to facilitate deferred exchanges, is a wholly owned subsidiary of an escrow company that has performed routine escrow services for Bill in the past. Cathy's Exchange Service has previously been retained by Bill to act as an accommodator in prior §1031 exchanges.

Cathy's Exchange Service is not a disqualified person notwithstanding the accommodator services previously provided by Cathy's Exchange Service to Bill and notwithstanding the combination of Cathy's Exchange Service's relationship to the escrow company and the escrow services previously provided by the escrow company to Bill (§1.1031(k)-1(k)(5)(Example 2)).

Example Escrow Company Owned by Exchanger's Lawyer. Exchange Law, Inc. is a corporation that is only engaged in the trade or business of acting as an accommodator to facilitate deferred exchanges. Each of ten law firms owns 10 percent of the outstanding stock of Exchange Law, Inc.. One of the ten law firms that owns 10 percent is Dewey, Cheetam & Howe, Attorneys-at-Law. Sam is the managing partner of Dewey, Cheetam & Howe and is also the president of Exchange Law, Inc. Sam, in his capacity as a partner in Dewey, Cheetam & Howe, has also rendered legal advice to Bill within the 2-year period ending on May 17, 2010, on matters other than exchanges intended to qualify for nonrecognition of gain or loss under §1031.

Sam and Dewey, Cheetam & Howe, Attorneys-at-Law are disqualified persons. Exchange Law, Inc., however, is not a disqualified person because neither Sam nor Dewey, Cheetam & Howe own, directly or indirectly, more than 10 percent of the stock of Exchange Law, Inc.. Similarly, Sam's participation in the management of Exchange Law, Inc. does not make it a disqualified person (§1.1031(k)-1(k)(5)(Example 3)).

Direct Deeding.

Does "acquire" mean that the accommodator (e.g., buyer/seller/facilitator) actually has to momentarily take physical title to both properties? No. Some accommodators take momentary or "sequential" title for administrative purposes, but it is not necessary.

> ***Caution!*** This "blink-of-the-eye" ownership can be potentially catastrophic for the buyer/seller/accommodator in light of the hazardous waste liability (i.e., Superfund or toxic waste liability). The liability to pay for cleanup costs in removing hazardous, toxic, or dangerous waste found on a property reaches any owner of a property even if that owner did not create such waste or cause its release into the environment.

To answer the above concern, the IRS came up with its own definition of the word acquire, probably to comply with previous judicial decisions (Rev. Rul. 90-34, I.R.B. 1990-16; §1.1031(k)-1(g)(4)(iv)), ***Biggs v. Comm***., 69 TC 905 (1978); ***Brauer v. Comm***., 74 TC 1134 (1980)).
.

Acquiring: Acquiring, in the deferred exchange regulations, rejects the general tax principle definition of acquisition for deferred exchange purposes and treats accommodators as if they acquired and transferred title, if they:

1. actually acquire and transfer legal title to that property (the least desirable option); or
2. enter into an "agreement" (e.g., an assignment) with a person other than the taxpayer (either on its own behalf or as the agent of any party to the transaction) for the transfer of the relinquished property to that person and, pursuant to that agreement, the relinquished property is transferred to that person; or
3. enter into an agreement with the owner of the replacement property (either on its own behalf or as the agent of any party to the transaction) for the transfer of that property and, pursuant to that agreement, the replacement property is transferred to the taxpayer (§1.1031(k)-1(g)(4)(iv)).

Replacement properties transferred to wholly-owned single member LLC O.K. The transfer of an S corporation's replacement properties received in a like-kind exchange to its wholly-owned single member limited liability company (LLC) did not violate the §1031 requirement that the taxpayer's replacement property must be held for productive use in a trade or business after the exchange. The LLC either elected to be disregarded as an entity separate from its owner or would rely on the default classification rule for single-owner entities under §301.7701-3(b)(1)(ii) (LTR 200131014).

Assignment of contract permitted. Solely for these purposes, an accommodator is treated as entering into an agreement if the rights of a party to the agreement are assigned to the accommodator and if all parties to that agreement are notified in writing of the assignment on or before the date of the relevant transfer of property (§1.1031(k)-1(g)(4)(v)).

The accommodator never has to take technical title! The transfer of property in a deferred exchange that is facilitated by the use of a qualified accommodator may actually occur via a direct deed of legal title by the current owner of the property to its ultimate owner (§1.1031(k)-1(g)(4)(iv)).

Deferred Exchanges

Your client wants to sell some property for cash with the plan to reinvest it in the future and during the interim deposit the money in an interest-bearing account but not pay the capital gains tax associated with the sale, (i.e., defer the gain). Until December 1979, most tax practitioners said "impossible!" We assumed that the trading of property had to be done concurrently. Then along came the Starker cases, commonly known as Starker I, Starker II, and Starker III, from Corvallis, Oregon, which has made the impossible a reality (***Bruce Starker v. U.S***. DC-Ore 75-1 USTC 9443; ***T.J. Starker v. U.S.***, 432 F. Supp 864 (DC-Ore. 1977), 602 F.2d 1341 (CA-9, 79-2 USTC 9451)).

The *Starker* Facts

T.J. Starker (T.J.) owned $1,502,500 of timbered property that Crown Zellerbach Corporation (Crown) wanted to buy. T.J. wished to effect a like-kind exchange but, after viewing Crown's present land assets, found none to his liking. The two parties entered into an exchange agreement wherein T.J. would immediately transfer title to Crown. In return, Crown would record an unsecured $1,502,500 "exchange value credit" on its financial records. In addition, Crown would purchase property over the next five years that T.J. found acceptable and that he instructed Crown to purchase. After Crown's purchase, the corporation would transfer title to T.J. and reduce the "exchange value credit" by the purchase price of the property. If any cash was left at the end of the fifth year, the remaining cash would be transferred to T.J. as T.J. did not have the right under the contract to demand cash in lieu of property.

In addition, the account was credited with an annual 6 percent "growth factor" (some, including the courts, called it disguised interest), theoretically to reflect timber growth on the parcels conveyed by the taxpayer.

Although the taxpayer selected nine like-kind parcels to be conveyed, none of which was owned by T.J. at the time the exchange agreement was executed, the Ninth Circuit Court of Appeals found that the taxpayer did not have control over the cash used by Crown to purchase these parcels. The transaction was held by the Ninth Circuit to constitute a §1031 exchange and T.J.'s additional $301,000 tax assessment was refunded to him as the gain was declared not to be recognized.

Problem with Starker exchanges: How long? How long could Starker defer identifying and locating the property? Theoretically, if it was more than six years, the statute of limitations would have made any cash remaining exempt from taxes. This problem was solved by Congress in 1984 by the "deferred exchange" rules, followed by IRS interpretative regulations finalized on May 1, 1991.

Time Limits Imposed on Deferred Like-kind Exchanges

For any deferred exchanges, the following limits apply:

1. ***Identified:*** All properties to be received must be identified within 45 days after the taxpayer transfers the relinquished property.

2. ***Received:*** The exchange of titles must be completed, or properties received, within strict time limits, not more than 180 days (or, if earlier, the due date, including extensions, of the taxpayer's tax return for the tax year the relinquished property was transferred) after the transfer of the exchanged property (§1031(a)(3); §1.1031(k)-1(b)(1)).

Caution! Filing a tax return on time can make a like-kind exchange taxable! A tax trap can occur by the 180 days "or, if earlier, the due date of the tax return" requirement. For example, if a calendar-year taxpayer gives property in a like-kind exchange on December 31, the 180 days would end on June 27 of the next year. But, if the individual files on April 15, this shortens the allowable exchange period to 105 days. As corporations file on March 15, they would only have 74 days to complete an exchange! Luckily, the requirement adds "including extensions." In other words, if the taxpayer files on time, they lose the period of time from the filing date to the end of the 180 days. Orville Christensen received replacement property after filing his tax return but before the 180 days . . . and no §1031 like-kind exchange was allowed (***Orville E. Christensen v. Comm.,*** (CA-9), 98-1 USTC ¶50,352).

Penalty for noncompliance. If these dates (i.e., 45/180 days) are not strictly followed, any property received outside these dates is considered "not-like-kind" property. Therefore the tax-free transaction is deemed a taxable sale and a subsequent purchase (§1.1031(k)-1(a)). The replacement period cannot be extended, ***even when the failure is beyond seller's control*** (***Knight,*** TCM 1998-107)

Time starts when first property transferred. Once the old property is conveyed, the period for identifying the replacement property ends exactly 45 days later and the period for receiving the property ends exactly 180 days later – no extensions are available. If, as part of the same deferred exchange, the exchanger transfers more than one relinquished property and the relinquished properties are transferred on different dates, the identification period and the exchange period are determined by reference to the earliest date on which any of such properties are transferred, and ends exactly 45/180 days (or filing date) later, even if the beginning or ending date is a Saturday, Sunday or legal holiday, (§1.1031(k)-1(b)(1)(iii)).

Rules to Identify the Replacement Property Within 45 Days

The IRS promulgated strict rules on how to identify properly the property in the 45-day period, but it does not require the filing of separate identification forms.

The identification time period. The identification period begins on the date the taxpayer transfers the relinquished property and ends at midnight 45 days thereafter (§1.1031(k)-1(b)(2)(i)).

Example. Karen transfers a $100,000 fair market value rental property to Sharon in a deferred exchange on May 17, 2009. On July 2, 2009, Karen hand-delivers to Sharon written, signed instructions to purchase a $100,000 office building.

Transfer of property: May 17, 2009
45 days from transfer: July 1, 2009
Delivery of identification instructions: July 2, 2009

Result. No §1031 exchange as the replacement property was identified outside the 45-day identification period [§1.1031(k)-1(c)(7)(Example 1)].

Not Timely Identifying Replacement Property Kills Tax-Free Swap. An accountant sold two properties, intending to do a tax-free swap pursuant to the like-kind rules under Code §1031. Sales proceeds were held in an escrow account, and two weeks later, he found a building that needed renovation but otherwise suited his needs. However, he was too busy to carry on the necessary negotiations for acquisition of the building and never formally identified it as the replacement before eventually buying it more than 45 days later. Worse yet, on the IRS Form 8824, he "mistakenly" (or so he said) inserted an identification date more than 45 days after the date the property was transferred. The Tax Court ruled that the exchange did not qualify under the like-kind rules. Even though he bought the building within the overall 180-day limitation period, he did not otherwise satisfy the 45-day identification rule, thus making the transaction taxable ***(Terry D. Smith***; TC Memo. 1997-109).

Properties Identified Within 45 Days, But All Sold to Others Before Exchanger Selected Property, Makes Deferred Exchange Impossible ... And Taxable! M. Michael Stewart sold her San Diego rental condominium on July 20, 2001, for $345,000, which would generate a $111,715 gain, so she had the gross proceeds deposited with First American Exchange Corporation (FAEC), intending to purchase other property in a like-kind §1031 exchange. On October 30, 2001 (101 days later), Michael requests the return of the funds held by FAEC, stating in a letter "[I've] determined that it is impossible for (the) qualified intermediary to acquire any of the identified Replacement Properties because they have been sold to other parties and are no longer for sale and therefore has made the above demand for the release of the funds." On October 31, FAEC wired the funds to Michael's bank account. Michael did not purchase other property within 180 days of the sale of the San Diego Condominium. By failing to timely find a replacement property, Michael failed to comply with the requirements of §1031 ... Michael has a taxable sale (or exchange). Not that it's relevant, her tax-deferred exchange would have also failed for other reasons, e.g., she "touched" the money when it was placed into her account and she violated the 45 day rule.

The Property Description Must Be Unambiguous

- **Describing real property.** Exchanger may use legal description, street address or distinguishable name (e.g., Trump Tower).

- **Describing personal property.** Description must be specific (e.g., truck must designate make, model, and year) [§1.1031(k)-1(c)(3)].

> ***Example.*** Karen transfers a $100,000 fair market value rental property to Sharon in a deferred exchange on May 17, 2009. On July 1, 2009, Karen hand-delivers to Sharon written, signed instructions to purchase "unimproved land located in Powder River County with a fair market value not to exceed $100,000."
>
> ***Result.*** No §1031 exchange, as the property description is not specific enough (§1.1031(k)-1(c)(7)(Example 3)).

Property that is to be produced or constructed in the future also qualifies but must follow special rules, which are discussed later in this material.

Limitations on How Many Replacement Properties May Be Designated

Regardless of the number of relinquished properties in the same deferred exchange, the maximum number of replacement properties the taxpayer may designate is three; if more than three properties are identified, then property value may not exceed twice the aggregate fair market value of the property given up; and if both more than three properties and more than twice fair market value are identified, then the exchanger must purchase 95 percent of all the properties identified.

Test 1 - the "three-property rule." The taxpayer may designate three properties of any fair market value (§1.1031(k)-1(c)(4)).

> ***Example.*** Karen transfers a $100,000 fair market value rental property to Sharon in a deferred exchange on May 17, 2009. On June 28, 2009 Karen hand-delivers to Sharon written, signed instructions identifying real properties J, K and L as potential replacement properties (fair market values of $75,000, $100,000 and $125,000, respectively). On August 1, 2009, Karen informs Sharon which of the three properties she wishes.
>
> ***Result.*** §1031 exchange available, as no more than three properties are identified within the proper time frame (§1.1031(k)-1(c)(7)(Example 4)).

What is a property? For example, Paul owns a ranch comprised of three separately purchased properties that are exchanged (one deed) with Susie for 20 commercial lots (again via one deed). Admittedly there are 23 separate parcels, but are there two or 23 properties?

There is no specific answer in the §1.1031(k)-1 deferred exchange regulations. The "multiple-property" exchange regulations conclude that the three ranch properties are one "exchange group" and the 20 lots are one "exchange group" (§1.1031(j)-1(a)(2)(i)).

Test 2 - The "200 percent rule." If the taxpayer designates more than three properties, the total fair market value of all the identified properties may not exceed 200 percent of the fair market value (on the transfer date) of the property given up (§1.1031(k)-1(c)(4)).

Example. Karen transfers a $100,000 fair market value rental property to Sharon in a deferred exchange on May 17, 2009. Also on May 17, Karen hand-delivers to Sharon written, signed instructions identifying real properties M, N, P and Q as potential replacement properties (with fair market values of $30,000, $40,000, $50,000 and $60,000, respectively). The written document provides that by July 2, 2009, Karen will orally inform Sharon which of the identified properties Sharon is to transfer to her.

Result. §1031 exchange available. Even though more than three properties were identified within the proper time frame, the aggregate fair market value ($180,000) does not exceed 200 percent of the property given up ($100,000 x 200%) (§1.1031(k)-1(c)(7)(Example 5)).

Test 3 - Purchase 95 percent of all identified property. If the taxpayer purchases 95 percent of the aggregate fair market values of all properties originally identified, the three-property and the 200 percent limitation rules do not apply. For this purpose, the fair market value of each identified replacement property is determined as of the earlier of the date the property is received by the taxpayer or the last day of the exchange period (§1.1031(k)-1(c)(4)(ii)).

Caution! Violation of all three tests makes the exchange fully taxable (§1.1031(k)-1(c)(4)(ii)).

Blanket 45-day exception. If all the property to be acquired is received within 45 days, the identification rule is waived (§1.1031(k)-1(c)(1)).

Segregating incidental property disregarded. For both the three-property rule and the 200 percent rule, property need not be separated if

1. in a standard commercial transaction, the property is typically transferred together with the larger item of property and
2. the aggregate fair market value of all such property does not exceed 15 percent of the aggregate total (§1.1031(k)-1(c)(5)(i)).

Example. Furniture, laundry machines and other miscellaneous items of personal property will not be treated as separate property from an apartment building with a fair market value of $1,000,000 if the aggregate fair market value of the furniture, laundry machines and other personal property does not exceed $150,000. In such case, for purposes of the three-property rule, the apartment building, furniture, laundry machines and other personal property are treated as one property. Moreover, when describing replacement property, the apartment building, furniture, laundry machines and other personal property are all considered to be unambiguously described if the legal description or street address of the apartment building is specified, even if no reference is made to the furniture, laundry machines and other personal property (§1.1031(k)-1(c)(5)(ii)(Example 2)).

Caution! Incidental property does not have to be specifically identified or counted for the 45-day identification period. Separate classes of property must be segregated when calculating the results of the tax-deferred exchange!

Previously identified property may be revoked before end of the 45 days. Taxpayers may change their minds and substitute other property they wish to identify at any time before the end of the 45-day identification period so long as the revocation is done in substantially the same manner as the original identification (i.e., written, signed and delivered revocation to the person originally notified) (§1.1031(k)-1(c)(6)).

How to Receive Property Properly within the Required Time Frame

Taxpayer must receive property by the filing date but no later than 180 days after transfer. The regulations provide that replacement property is received before the end of the exchange period (i.e., the filing date or 180 days after transfer) if the replacement property received is "substantially the same" property as was identified (§1.1031(k)-1(d)(1)).

If the taxpayer identifies more than one replacement property, the receipt rules apply separately to each.

No extension of time, even when delay created by the court outside the taxpayer's control. A taxpayer was not entitled to the suspension of the 180-day replacement period under §1031 for its replacement property to qualify for nonrecognition treatment. The taxpayer was prevented from purchasing replacement property due to funds being frozen as part of receivership proceedings. Nothing in the language of §6503(b) supported the taxpayer's contention that suspension afforded by §6503 is properly relied upon to suspend the 180-day period under §1031 where a taxpayer's assets are within court custody or control (LTR 200211016).

The exchange period. The exchange period begins on the date the taxpayer transfers the relinquished property and ends on the earlier of the 180 days thereafter or the due date (including extensions) for the taxpayer's tax return for the taxable year in which the transfer of the relinquished property occurs (§1.1031(k)-1(b)(2)(ii)).

The Construction Exchange

One of the strangest provisions in the final regulations permits, with limitations, the taxpayer to participate in an exchange even if the replacement property is not in existence, or is being produced, at the time the property is identified (§1.1031(k)-1(e)(1); PLR 9413006). The tricky part is that the replacement property must still be properly identified (within the 45 days) and received within the proper time frame (i.e., 180 days). To produce includes to construct, build, install, manufacture, develop, or improve (§263A(g)(1)).

Replacement property being produced must be properly "identified." Identification must be as accurate as possible, (e.g., for buildings to be constructed, use the legal description of the land and as much detail as practical) (§1.1031(k)-1(e)(2)(i)). For the 200 percent rule and the incidental rule, the taxpayer must use the fair market value of the property as of the date it is expected to be received by the taxpayer (§1.1031(k)-1(e)(2)(ii)).

The constructed property must be substantially the same as identified. If substantial changes are made after identification, the replacement property will not be considered substantially the same as identified and the exchange will be deemed a taxable sale and subsequent repurchase. Variations due to usual or typical production changes are not taken into account (§1.1031(k)-1(e)(3)(i)).

Receiving personal property. There is no extension of time (i.e., for the 180-day rule), and the property must be finished within the exchange period (§1.1031(k)-1(e)(3)(ii)).

Receiving real property - it doesn't have to be finished! There is no extension of time (i.e., for the 180-day rule), and if the real property is in the construction phase (but not completed at time of receipt), the end product must be substantially the same as originally identified. However, real property does not have to be completed within the exchange period (§1.1031(k)-1(e)(3)(iii)).

Can we extend the 180 days through the back door? Probably. As the 180 days do not start to toll until after the taxpayer transfers the relinquished property, simply stalling the closing date results in extending the time (§1.1031(k)-1(b)(2)(ii))). This should not be too risky if the legal contracts contain a "specific performance" clause and a large down payment.

Like-Kind Exchange Failed Due to Constructive Receipt of Proceeds

Taxpayer wanted an exchange but touched the cash. Ralph Crandall and Dene Dulin owned an undeveloped parcel of property in Lake Havasu City, Arizona (Arizona property) which they purchased for $8,500. They held the Arizona property for investment. Ralph and Dene desired to own investment property closer to their California residence. After receiving some limited advice concerning a tax-free exchange of properties, Ralph and Dene took steps to sell the Arizona property and purchase new property with the intention of executing a tax-free exchange. On March 4, 2005, Ralph and Dene sold the Arizona property for $76,000. The buyers of the property paid Ralph and Dene $10,000, and the remaining $66,000 was placed in an escrow account with Capital Title Agency, Inc. (Capital Title). At Ralph and Dene's direction $61,743.25 was held in the escrow account. Capital Title initially released $4,256.75 to Ralph and Dene.

At closing, sale and purchase documents were used not exchange documents. Most important, the Capital Title and Chicago Title escrow agreements did not reference a like-kind exchange under §1031, nor did they expressly limit Ralph and Dene's right to receive, pledge, borrow, or otherwise obtain the benefits of the funds. To support their argument that is was a like-kind exchange, Ralph and Dene testified that the funds in the Capital Title escrow account were held solely for the purchase of the California property and that they received no proceeds from the sale of the Arizona property.

Court ruled that transaction was a sale and a reinvestment, not an exchange. The court concluded that the disposition of the Arizona property was a sale and the funds deposited in the Capital Title escrow account represent the receipt of the proceeds. Consequently, Ralph and Dene's transaction did not qualify for §1031 nonrecognition, and they must recognize gain for 2005. The Court noted that the tax consequences were are not what Ralph and Dene intended and the result may have been somewhat harsh. However, Congress enacted strict provisions under §1031 with which taxpayers must comply.

The court had no doubt that Ralph and Dene intended the transaction to qualify under the provisions of §1031. However, the court pointed out, it was well established that a taxpayer's intention to take advantage of tax laws did not determine the tax consequences of his transactions . (***Ralph E. Crandall and Dene D. Dulin v. Comm***., TCS 2011-14)

Accidentally "Touching the Money" Didn't Destroy Deferred Exchange

Owner of Hard Rock Cafe wanted to treat the sale of his G-III jet and subsequent purchase of a G-IV jet as a like-kind exchange. Peter Morton is one of the co-founders of the Hard Rock Café chain, and the creator and developer of the Hard Rock brand. Morton's C corporation owned and operated the Hard Rock Hotel and Casino (HRH) in Las Vegas, and he personally performed management services for HRH (his salary was a percentage of HRH's gross income). Morton used a Gulfstream-III (G-III) and a Gulfstream-IV (G-IV) aircraft to facilitate his multiple business activities and deducted the expenses. Morton sought to exchange the G-III for a G-IV aircraft. He entered into an agreement with a qualified intermediary for the exchange and an escrow agreement with an escrow agent. The escrow agent accidentally, and in contravention of the escrow agreement, wired funds from the escrow account to one of Morton's S corporations. Morton's CFO returned the funds to the escrow agent the following day.

The IRS argued "we caught you" after discovering the escrow agent accidentally sent the money to the taxpayer instead of the accommodator. In audit, of course, the IRS found the "mistake" and reclassified the exchange as a sale (creating a taxable gain) and subsequent repurchase. The IRS acknowledged that Morton abided by the "qualified accommodator" requirements and would have effected a valid like-kind exchange but for the accidental placement of funds into the S corporation's account instead of the escrow agent's account. But, the IRS stressed the law is the law; the facts showed before the funds were placed in escrow, the money was deposited into Morton's S corporation's checking account. Thus, as a fact, the IRS contended that because the S corporation had possession and control over the funds, Morton had "actual receipt" of them.

Exchange agreement overrides accidental transfer of funds. The court disagreed that an accidental transfer followed by an immediate return of funds would constitute actual or constructive receipt. Significantly, to the court, Morton was bound by contract not to "receive, pledge, borrow or otherwise obtain the benefits of the Exchange Value" for at least 45 days. The court pointed out that, legally, he could not do anything but return the funds to the proper account. If he had done anything other than return the funds, he would have been liable for conversion, or even theft.

Court tells IRS to "get real." Additionally, Morton should not be penalized for another's mistake when he took every step to effect validly a deferred like-kind exchange. Morton complied with all the requirements of the qualified intermediary safe harbor over which he had control; he did not have control over the mistaken actions of a third party. Because he complied with the requirement in all other aspects, the court concluded that Morton validly effected a deferred like kind exchange (***Peter Morton v. U.S.,*** 2011-1 USTC ¶50,346).

Reporting §1031 Exchanges

Most investors and tax preparers consider the like-kind exchange computation to be very difficult. After looking at the IRS's Like-Kind Exchange Form 8824 and the variety of worksheets available, you may be inclined to confirm this misconception. Don't let the forms scare you. Nothing could be further from the truth.

Step 1: Follow the Rules

Exchanges start with negotiating the financial economics, not the tax ramifications, of the transaction. Generally your client has decided already on disposing of what will soon be the relinquished property. Then he or she comes to you for tax advice.

The IRS Rules

These have been discussed at length in the previous pages. To qualify as a nontaxable exchange:

- Exchange qualifing property
- Exchange like-kind property
- Receive no cash
- Receive no net mortgage relief
- Use an accommodator/qualified exchange facilitator
- Stay within the deadlines for deferred exchange

Karen's 3 Simple Rules

- Always trade even or up (FMV)
- Never, never, never receive any cash
- Always end up with at least as much or more mortgage as you had to start

I know those rules sound simple, but because I insist my clients all use qualified intermediaries/exchange accomodators, and I trust the accommodator to impose all the deferred transaction rules, these 3 rules will produce a tax-deferred exchange every time.

Step 2: Determine the Basis and Expenses

Outside of the closing statements for all property transactions, only two other pieces of information are needed for the exchange calculation:

1. The exchange expenses
2. The adjusted basis of the property given

Step 3: Calculate

I use an uncomplicated two-page Excel worksheet to "number-crunch" the accumulated data. This worksheet is divided into five parts:

1. Cash Received
2. Cash Paid
3. Realized Gain
4. Recognized (Taxable) Gain
5. Basis of New Property

It is easy. We only need escrow statements (HUD-1s) and to accumulate financial data for the exchange expenses and adjusted basis calculation. Once we have these figures, the calculation is a simple arithmetic exercise. This sum determines the nontaxable portion of the gain.

Boot and Basis

Calculating and reporting §1031 exchanges often become bogged down in discussions of "boot" and basis. As you've seen, however, it isn't necessary to delve into all that minutiae just to properly report the transaction. Nevertheless, no manual on §1031 is complete without this information.

Boot

The amount of boot received is the sum of any money and the fair market value of other nonqualified property the exchanger receives. Therefore, boot consists of money, liabilities assumed (or attached to the property received in exchange), nonqualifying property (such as cash, inventory, or stocks and bonds) and property that does not meet the like-kind definition (such as trading business property for personal property) (§1031(b); §1.1031(b)-1)). It even includes cash received several years before the exchange for an option on the relinquished property, with the option money treated as boot during the year in which the exchange is completed (PLR 9413024). However, there is a price to pay when receiving boot.

Gain may be recognized to the lower of the gain or the boot. If nonqualifying property, or boot, is received in an exchange that otherwise consists of like-kind property, gain will be recognized (i.e., taxable) but not in excess of such money (and liabilities relieved of) and the fair market value of such other unlike property. This is basically saying that the taxpayer will not be required to pay more tax than would have been paid if the property had been sold for cash (§1031(b); §1.1031(b)-1(a)).

If a taxpayer receives, in addition to qualified like-kind property, either money or other property, any loss realized on the exchange is not recognized, that is, not deductible. This is true even if the loss on the exchange is created solely by the exchange brokerage commission. The loss is added to the fair market value of the property received (§1031(c); (Rev. Rul. 72-456, 1972-2 CB 468)).

Giving boot, or nonqualifying property, along with giving qualifying property in an exchange does not completely remove the transaction from §1031. Nevertheless, the transfer of non-money boot is treated as a sale of such property with respect to which any gain or loss is taxable. The taxpayer is deemed to receive in exchange for the nonqualifying property transferred an amount equal to its fair market value (§1.1031(a)-1(a); §1.1031(d)-1(e); §1.1031(d)-1(e)).

Netting boot. In certain circumstances, the taxpayer may net the (taxable) boot received by any boot given (such as the netting of liabilities), thereby lowering the gain to be recognized.

As mortgage relief is considered boot and treated as if it is money received by the taxpayer in the exchange, this can result in a disastrous tax consequence. Any mortgage assumed, or taken subject to, creates taxable gain for the party being relieved of the debt...to the extent of the total gain (§1031(d); §1.1031(b)-1(a)).

If each exchange party assumes the liability of the other party, the parties are allowed to net their liabilities when calculating the amount of the taxable boot received. Even the issuance of the exchanger's own promissory note is considered boot given, which may be offset against mortgage relief. Therefore, only when taxpayers realize a net reduction in their debt do they experience taxable boot (§1.1031(b)-1(c); §1.1031(d)-2, Example 2; Rev. Rul. 79-44, 1979-1 CB 265).

Cash (and other property) given may be netted against mortgage received. The giving of cash and the fair market value of other nonqualifying property (property boot) is also netted against any relief of liabilities (1.1031(d)-2, Example 1; ***Coleman v. Comm.,*** 180 F2d 758 (8th Cir. 1950); Rev. Rul. 79-44).

But cash (and other property) received cannot be offset against mortgage given. Receipt of cash or other nonqualified property in a §1031 exchange cannot be offset by the assumption of liabilities. Therefore, the IRS prohibits netting when the exchanger both receives cash and receives a mortgage debt from the other party (§1.1031(d)-2, Example 2).

Exchange expenses. Certain transaction expenses of the §1031 exchange, such as brokerage commissions paid, reduce the total consideration received and increase the basis of the exchange property received (Rev. Rul. 72-456, 1972-2 CB 468). In ***Westall v. Comm.***, 56 TCM 66 (1988), the court held that the taxpayer's cash received was offset by all the taxpayer's selling expenses and did not delineate the type of selling expenses involved.

May we refinance just prior to the exchange? Planning that the IRS doesn't like. In order to equalize their net equities, taxpayers sometimes place a mortgage on their property just prior to closing, with the result that they put cash in their pocket, tax-free. If the cash were paid at closing to that same taxpayer, the cash would be considered taxable boot . Needless to say, this "tax-planning device" is not favorably viewed by the IRS

But the Tax Court held, with an IRS acquiescence, that the assumption of a liability by a taxpayer in a like-kind exchange will be recognized even though the liability was placed on the property immediately before the exchange at the taxpayer's prompting so as to avoid the recognition of gain under the mortgage netting rule (***Garcia v. Comm.,*** 80 TC 491 (1983), acq. 1984-1 CB 1; PLR 8248039). Any refinancing after the exchange should also be permitted (***Carlton v. U.S***., 385 F2d 238 (5th Cir.), 1967).

The Basis of Property Received.

Computing the basis on the new property is simple when the exchange involves only property for like-kind property. The new basis of the property received in a tax-free exchange is the basis of the old property surrendered. This new unadjusted basis is known as the property's substituted basis and preserves the potential gain (or loss) on the disposed building for future recognition [§1031(d); §1.1031(d)-1(a)].

This substituted-basis rule becomes complicated, though, when the exchange involves the paying or receiving of cash, netting of liabilities, giving or receiving of other boot, or if a loss is recognized because unlike property is transferred in the exchange along with the like-kind property.

The technical formula to calculate basis of property received. In a tax-free exchange, the new basis is the basis of the old property surrendered, increased by any money (including debt) given and the amount of any gain recognized, and decreased by the amount of money (including debt) received and any loss recognized on the exchange. Therefore, payment of cash and net mortgage debt assumed increases the new basis. Any brokerage commissions and other exchange expenses paid by the exchanger also increases basis (§1031(d); §1.1031(d)-1); Rev. Rul. 72-456, 1972-2 CB 468; ***Westall v. Comm.,*** 56 TCM 66 (1988)).

> ***Hint.*** Said another way, if the exchange is tax-free, the exchanger's old basis is reduced by the cash received and mortgage relief (i.e., "cashed out") and increased by the cash given and the mortgage acquired (i.e., "cash in").

Basis when boot is given. As mentioned previously, the basis of the new property received in a tax-free exchange is the basis of the old property surrendered, increased by any money (including debt) given (§1031(d); §1.1031(d)-1).

Basis when cash boot is received and gain is recognized. In a tax-free exchange, the exchanger's new basis is the basis of the old property surrendered, increased by any money (including debt) given plus the amount of any gain recognized and decreased by the amount of any money (including debt) received (§1031(d); §1.1031(d)-1).

Allocating basis when property boot is received and gain recognized. When the exchanger receives boot property and gain is recognized because of the receipt of the boot, the adjusted basis of the property given, decreased by the amount of cash received and increased by the amount of gain recognized, must be allocated to the properties (other than money) received on the exchange. The basis is first allocated to the boot property to the extent of the boot property's fair market value (§1.1031(d)-1(c)).

Allocating basis when boot is received and nondeductible loss exists. No loss is recognized even when other property or money is received. The basis of the property(ies) (other than cash) received is the adjusted basis of the property given, decreased by the amount of money received. This basis is allocated to the properties received, and there must be allocated to such other property an amount of such basis equivalent to its fair market value (§1.1031(d)-1(d)).

Allocating basis when gain or loss on boot property is recognized. When an exchanger exchanges boot property and the boot property creates the recognized gain or loss (§1002), basis is first allocated to the boot property (other than money or liabilities) to the extent of its relative fair market on the date of the exchange, and the balance is allocated among the qualifying property received, based on its relative fair market value on the date of the exchange (§1.1031(d)-1(e)).

Loss on not-like-kind property given. Where loss is recognized on a partially tax-free exchange because unlike property is transferred by the taxpayer as part of the exchange, the recognized loss decreases the basis of the property received. For purposes of this rule, the amount regarded as having been received in exchange for the "other" property is its fair market value on the date of the exchange (§1.1031(d)-1(e)).

Allocation of basis when more than one property received. If more than one property is received in the exchange, the basis of the property given is allocated to the properties received in proportion to their fair market values on the date of the exchange (Rev. Rul. 68-36, 68-1 CB 357; §1.1031(j)-1(c); ***Laster v. Comm.,*** 43 BTA 159 (1940)).

What is done with the land in an exchange? The basis allocated to each rental must subsequently be allocated between the land and building, again on the basis of their relative fair market values (§1.61-6(a)).

Other §1031 Exchange Considerations

The world of §1031 is complex, and ever-changing. What follows are some additional topics often encountered with taxpayers in the course of a like-kind exchange.

The "Reverse Starker" Exchange

Can a taxpayer do a like-kind exchange with property that he/she already owns? Sometimes an outside party also is trying to buy the seller's property before the exchanger/taxpayer can secure it. It is often asked: "Can the exchanger purchase the seller's property *before* the buyer transfers his or her property to the exchanger?" The general answer is no, as this results in a purchase with a subsequent taxable sale, and the evidence is the title transfer (***Smith v. Comm***., 537 F2d 972 (8th Cir. 1976); §1.1031(k)-1(a)).

Yet, in two private letter rulings, the IRS allowed a utility company to acquire a utility easement before the original utility easement was disposed of (i.e., a reverse exchange of utility easements) without commenting on the previous citations or even the issue. "The facts of this case present a reverse exchange transaction between two parties, in which the conveyance of the new easement to the Taxpayer is to be followed by relinquishment to Company F of the old easement. The real property interests involved are similar to each other and the new easement will serve functions identical to those of the old easement" (PLR 9814019 and 9823045).

> **Note**: Some other alternatives exist, though, that allow the exchanger to control disposition of the property prior to the time of the exchange without technically purchasing the property, such as the use of a lease or a purchase option. Another option is described below.

The "Reverse Starker" Exchange – Accommodators May Purchase Before Exchange.

An accommodator may acquire the seller's property in contemplation of the exchange, and subsequent to the closing time the accommodator can negotiate a transfer to the buyer, if desired. This is then followed by the buyer, accommodator and the exchanger affecting the exchange. Both the Tax Court and the Fifth Circuit conclude that a §1031 exchange is being properly completed in this situation. *And, the exchanger can loan the accommodator the money to acquire the seller's property.* The loan is repaid from the buyer's cash purchase (***Biggs v Comm.***, (69 TC 905 (1978), *aff'd,* 632 F2d 1171 (5th Cir. 1981)); ***124 Front Street, Inc***., 65 TC 6 (1975)).

Reverse Starker Exchanges - IRS Provides Safe Harbor

The IRS fulfilled its promise to provide guidance on reverse-Starker exchanges, a promise made in 1991 in the preamble to the final regulations for deferred like-kind exchanges. Rev. Proc. 2000-37 provides guidance on how to structure a transaction that will qualify under §1031 as tax deferred when the replacement property must be acquired before the disposition of the old property.

Reverse Starker exchanges since 1991. To facilitate reverse like-kind exchanges, taxpayers have engaged in a wide variety of transactions including so-called "parking" transactions, i.e., one of the properties is "parked" with an accommodation party. In the parking arrangements, taxpayers attempt to arrange the transaction so that the accommodation party has enough of the benefits and burdens relating to the property so that the accommodation party will be treated as the owner for federal income tax purposes. Rev. Proc. 2000-37 provides a safe harbor that allows a taxpayer to *treat the accommodation party as the owner of the property* for federal income tax purposes, thereby enabling the taxpayer to accomplish a qualifying like-kind exchange.

Replacement property is owned by accommodator. In some situations the desired replacement property is "parked" with an accommodation party until such time as the taxpayer arranges for the transfer of the relinquished property to the ultimate transferee in a simultaneous or deferred exchange. Once such a transfer is arranged, the taxpayer transfers the relinquished property to the accommodation party in exchange for the replacement property, and the accommodation party then transfers the relinquished property to the ultimate transferee.

Relinquished property is owned by accommodator. In other situations, an accommodation party may acquire the desired replacement property on behalf of the taxpayer and immediately exchange such property with the taxpayer for the relinquished property, thereafter holding the relinquished property until the taxpayer arranges for a transfer of such property to the ultimate transferee.

Safe harbor for qualified exchange accommodation arrangements. Specifically, Rev. Proc. 2000-37 provides that the IRS will not challenge the qualification of property as either "replacement property" or "relinquished property" (as defined in §1.1031(k)-1(a)), or the treatment of the exchange accommodation titleholder as the beneficial owner of such property for federal income tax purposes, if the property is held in a Qualified Exchange Accommodation Arrangement (QEAA). For purposes of this revenue procedure, property is held in a QEAA if all of the following seven requirements are met:

1. ***Ownership not vested in taxpayer or disqualified person:*** Qualified indicia of ownership of the property is held by a person (the "exchange accommodation titleholder") who is not the taxpayer or a disqualified person and such person is subject to federal income tax. If the exchange accommodation titleholder is treated as a partnership or S corporation for federal income tax purposes, more than 90% of its interests or stock must be owned by partners or shareholders who are subject to federal income tax. Such qualified indicia of ownership must be held by the exchange accommodation titleholder at all times from the date of acquisition by the exchange accommodation titleholder until the property is transferred.
2. ***What is qualified indicia of ownership?*** For this purpose, "qualified indicia of ownership" means legal title to the property, other indicia of ownership of the

property that are treated as beneficial ownership of the property under applicable principles of commercial law (*e.g.*, a contract for deed), or interests in an entity that is disregarded as an entity separate from its owner for federal income tax purposes (*e.g.*, a single member limited liability company) and that holds either legal title to the property or such other indicia of ownership;

3. ***Intent to qualify under §1031:*** At the time the qualified indicia of ownership of the property is transferred to the exchange accommodation titleholder, it is the taxpayer's bona fide intent that the property held by the exchange accommodation titleholder represent either replacement property or relinquished property in an exchange that is intended to qualify for nonrecognition of gain (in whole or in part) or loss under §1031;
4. ***Written agreement within five days:*** No later than five business days after the transfer of qualified indicia of ownership of the property to the exchange accommodation titleholder, the taxpayer and the exchange accommodation titleholder enter into a written agreement (the "qualified exchange accommodation agreement") that provides that the exchange accommodation titleholder is holding the property for the benefit of the taxpayer in order to facilitate an exchange under §1031 and Rev. Proc. 2000-37 and that the taxpayer and the exchange accommodation titleholder agree to report the acquisition, holding, and disposition of the property as provided in Rev. Proc. 2000-37. The agreement must specify that the exchange accommodation titleholder will be treated as the beneficial owner of the property for all federal income tax purposes. Both parties must report the federal income tax attributes of the property on their federal income tax returns in a manner consistent with this agreement;
5. ***Identification of relinquished property within 45 days:*** No later than 45 days after the transfer of qualified indicia of ownership of the replacement property to the exchange accommodation titleholder, the relinquished property is properly identified. Identification must be made in a manner consistent with the principles described in §1.1031(k)-1(c). For purposes of this section, the taxpayer may properly identify alternative and multiple properties, as described in §1.1031(k)-1(c)(4);
6. ***Transfer within 180 days:*** No later than 180 days after the transfer of qualified indicia of ownership of the property to the exchange accommodation titleholder, (a) the property is transferred (either directly or indirectly through a qualified intermediary (as defined in §§1.1031(k)-1(g)(4))) to the taxpayer as replacement property; or (b) the property is transferred to a person who is not the taxpayer or a disqualified person as relinquished property; and
7. ***Maximum time in QEAA is 180 days:*** The combined time period that the relinquished property and the replacement property are held in a QEAA does not exceed 180 days.

Example. Ron wants to exchange his 4-plex for an upscale duplex. Unfortunately, he finds the duplex of his dreams before he finds a buyer for the 4-plex. A qualified exchange accommodation titleholder may acquire ownership of the duplex and hold it for Ron until he finds a buyer for his property. Once Ron finds a buyer (must be within 180 days), he will exchange the 4-plex for the duplex. Providing the requirements of Rev. Proc. 2000-37 are met, Ron's reverse Starker exchange qualifies under §1031.

Permissible agreements: Property will not fail to be treated as being held in a QEAA as a result of any one or more of the following legal or contractual arrangements, regardless of whether such arrangements contain terms that typically would result from arm's length bargaining between unrelated parties with respect to such arrangements:

1. **Exchange accommodation titleholder may be qualified intermediary:** An exchange accommodation titleholder that satisfies the general requirements of the qualified intermediary (accommodator) safe harbor (as set forth in §1.1031(k)-1(g)(4)) may enter into an exchange agreement with the taxpayer to serve as the qualified intermediary in a simultaneous or deferred exchange of the property under §1031;
2. **Taxpayer may guarantee debt to buy property:** The taxpayer or a disqualified person guarantees some or all of the obligations of the exchange accommodation titleholder, including secured or unsecured debt incurred to acquire the property, or indemnifies the exchange accommodation titleholder against costs and expenses;
3. **Taxpayer may loan funds to buy property:** The taxpayer or a disqualified person loans or advances funds to the exchange accommodation titleholder or guarantees a loan or advance to the exchange accommodation titleholder;
4. **Taxpayer may use property:** The property is leased by the exchange accommodation titleholder to the taxpayer or a disqualified person;
5. **Taxpayer may improve or service property:** The taxpayer or a disqualified person manages the property, supervises improvement of the property, acts as a contractor, or otherwise provides services to the exchange accommodation titleholder with respect to the property;
6. **Predetermined price okay:** The taxpayer and the exchange accommodation titleholder enter into agreements or arrangements relating to the purchase or sale of the property, including puts and calls at fixed or formula prices, effective for a period not in excess of 185 days from the date the property is acquired by the exchange accommodation titleholder; and
7. **Taxpayer may or must cover fluctuations in value:** The taxpayer and the exchange accommodation titleholder enter into agreements or arrangements providing that any variation in the value of a relinquished property from the estimated value on the date of the exchange accommodation titleholder's receipt of the property be taken into account upon the exchange accommodation titleholder's disposition of the relinquished property through the taxpayer's advance of funds to, or receipt of funds from, the exchange accommodation titleholder.

> ***Caution!*** A legal document, generally called an exchange agreement, *must* exist evidencing the relationship between the exchanger and the accommodator.

How Not to Do a Reverse Starker Exchange

> ***Caution!*** This letter ruling (LTR 200039005) was released prior to the issuance of Rev. Proc. 2000-37. It has been included in this manual to illustrate how *not* to perform the so-called Reverse Starker exchange.

Taxpayer's agent receives replacement property prior to the date on which the taxpayer transfers the relinquished property: The original plan was for Bill to assign the contract of sale of his office building, the relinquished property, to Paul, the accommodator, who would complete the sale of the office building and use the proceeds to acquire Sharon's shopping center, the replacement property. Bill would then have the accommodator transfer the shopping center to him to complete the exchange. This would have resulted in a tax free exchange, whether a simultaneous or deferred like-kind exchange.

However, at closing, the attempted sale of his office building fell through. To make things worse, Sharon demanded that closing on the acquisition of the shopping center be completed immediately. Therefore, prior to contracting the sale of the office building, Bill closed on the purchase of the shopping center on *Date 1*, *but had the property titled to Paul, an accommodator.* (Remember, Bill could not have directly purchased the property as, under the like-kind exchange regulations, Bill *must* give up his property before receiving the replacement property.) Bill negotiated the purchase; Bill provided the funds; Bill was personally liable on the purchase money mortgage while Paul was not. Bill ordered that the shopping center be titled to Paul. There was no evidence that Paul would have been involved in the transaction but for Bill. The IRS therefore concluded that Paul was not a qualified like-kind exchange accommodator, but was actually acting as Bill, i.e., an agent of Bill.

On Date 2, Bill contracted to sell the office building to Susie. Bill then entered into an exchange agreement with Paul and assigned the contract of sale to Paul. On Date 3, Paul closed on the sale of office building to Susie, and on Date 4, Paul transferred part of the shopping center to Bill. On Date 5, Paul transferred the remainder of the shopping center to Bill. As Bill had actually purchased the shopping center on *Date 1* before disposing of the office building, the transfer on Date 5 was irrelevant **(LTR 200039005)**.

Reverse like-kind exchange deadlines may be postponed due to war or disaster (Notice 2005-3)**.** The last day of the 45-day identification period, 180-day exchange period limitation, and the last day of a period described under the reverse qualified exchange accommodation arrangement (QEAA) requirements that fall on or after the date of a presidentially declared disaster, under these modifications, are postponed by the later of:

1. 120 days; or
2. the last day of the general disaster extension period authorized by the IRS (in a news release or some other guidance).

A taxpayer qualifies for the extension if the relinquished property was transferred and the qualified indicia of ownership were transferred to the exchange accommodation titleholder (EAT) on or before the date of the presidentially declared disaster. In addition, the taxpayer must be an affected taxpayer or have difficulty meeting the 45- or 180-day deadlines because the relinquished or replacement property is located in the disaster area, the principal place of business of any of the parties is in the disaster area, a party to the transaction is killed or injured or missing, a document related to the transaction is destroyed or damaged as a result of the disaster, funding is pulled from the transaction, the insurance company cannot provide title insurance, or other similar reason (modifying Rev. Proc. 2004-13).

The postponement also applies to the last day of the 45-day identification period described in §1.031(k)-(1)(b)(2) or the 180-day period that applied to the exclusion from the safe harbor property held in a QEAA that is owned by the taxpayer pursuant to Rev. Proc. 2004-51, modifying Rev. Proc. 2000-37.

The proposed modifications are effective retroactively for acts performed on or after January 26, 2004, assuming, with respect to a presidentially declared disaster area, that the IRS has issued guidance authorizing postponement under §7508A.

IRS Illustrates Rev. Proc. 2000-37 With Property to be Constructed

An S corporation's transaction characterizing the transfer of relinquished property to a village in exchange for replacement property as a like-kind exchange conformed to the requirements of the qualified intermediary and qualified exchange accommodation agreement safe harbor rules. Consequently, the qualified intermediary and the exchange accommodation title holder were not construed as agents of the taxpayer, and the taxpayer, therefore, did not actually or constructively receive money or property before receiving the replacement property. As a result, the taxpayer did not recognize any gain or loss upon the conveyance of the relinquished property to the village for the replacement property so long as the agreed upon improvement were completed within the exchange period (LTR 200251008).

The entire proposed transaction at issue can be summarized in the following steps:
(1) Taxpayer will enter into the qualified exchange accommodation arrangement (QEAA) with an exchange accommodation titleholder (EAT), and will enter into an exchange agreement with qualified intermediary (QI) as described. (2) LLC-W will sublease the replacement property (RP) at a fair market rental, for 32 years, to Titleholder, a disregarded entity wholly owned by EAT, as part of a QEAA as defined in Rev. Proc. 2000-37. (3) Taxpayer will lend to Titleholder the funds which it (Taxpayer) will borrow from Husband's Trust, Wife's Trust and Bank to construct improvements necessary on leased property for relocation of Business. (4) Taxpayer will assign its rights under Sale Agreement of the relinquished property (RQ) to QI and will give required notices of such assignment to all interested parties. (5) Taxpayer will transfer RQ free and clear through QI to Village, and QI will receive sales proceeds. (6) Taxpayer will assign its position in

the QEAA to QI and give required notices of such assignment to all interested parties. (7) QI will use sales proceeds from RQ to pay EAT for all of its interest in Titleholder (which holds all of RP, consisting of leased property and newly constructed improvements to suit Taxpayer's business requirements). (8) EAT will use the proceeds received from QI (the consideration for the transfer of RP (Titleholder)) to pay Construction Manager and to pay the loan from Taxpayer in full (which Taxpayer will, in turn, use to pay the Bank Construction Loan in full). (9) QI will direct EAT to transfer its interest in Titleholder (holding RP) directly to Taxpayer.

Can Taxpayer Perform a “Reverse Starker” and a Delayed Exchange Using the Same Relinquished Property?

Taxpayer structured two separate exchanges, one a reverse exchange in which replacement property is acquired and “parked” with an exchange accommodation titleholder before the taxpayer transferred its relinquished property, followed by a standard deferred exchange in which the relinquished property is transferred prior to the acquisition of the replacement property.

For the reverse exchange, replacement property (RP) was acquired and parked with EAT within the guidelines of Rev. Proc. 2000-37, and Taxpayer identified relinquished property (RQ) in a timely manner. RQ, however, had a value far in excess of RP. Thus, Taxpayer intended to engage in a second like-kind exchange to defer the gain that remained after the exchange of RQ for RP. For both exchanges, the taxpayer used a qualified intermediary to execute the transfers of the properties involved in the exchanges. Further, all guidelines were followed to assure that the taxpayer was not in constructive receipt of any of the exchange funds during the two exchange periods. However, while Taxpayer in good faith intended to engage in a second exchange involving RQ, the second exchange was not completed.

Neither §1031, the regulations under § 1031, nor Rev. Proc. 2000-37 expressly allows the same relinquished property to be used in both a reverse exchange under Rev. Proc. 2000-37 and a deferred exchange. However, nothing in the statute, regulations or revenue procedure prohibits this coupling in the use of the same relinquished property. Also, taxpayers using the revenue procedure are not constrained to acquire exclusively as replacement property only the property parked with the exchange accommodation titleholder.

An argument has been made that Taxpayer’s transactions violate Congressional intent because (1) there could be up to 360 days between the day on which replacement property is parked with an exchange titleholder at the inception of the reverse exchange and the day the deferred exchange is completed, and (2) Taxpayer is entitled to two separate 45 day identification periods. The argument, therefore, is that the transactions are contrary to the identification and replacement provisions set forth in §1031(a)(3). However, these are not persuasive reasons for denying deferral, especially in view of the fact that there are two exchanges taking place instead of one.

A taxpayer is permitted 45 days to identify replacement property in a deferred exchange and 45 days to identify relinquished property once replacement property is parked. Taxpayer in the present case satisfied the identification requirement in both instances. Moreover, a taxpayer is permitted to park property with an exchange accommodation titleholder for a period not exceeding 180 days. Also, in a deferred exchange, a taxpayer must close its exchange by acquiring replacement property within the exchange period, which is the earlier of 180 days after the date on which the taxpayer transfers the property relinquished in the exchange, or the due date (determined with regard to extension) for the taxpayer's return of the tax imposed for the taxable year in which the transfer of the relinquished property occurs. Taxpayer in this case stayed within all of these guidelines (LTR 200836024).

Related Party Exchanges

Disposition within two years of exchange triggers deferred gain. If a taxpayer exchanges property with a related party (as defined below), the original exchange will not qualify for tax deferral if either of the exchanged properties is sold or disposed of within two years of the transfer. Interestingly, the postponed gain becomes taxable at the time of the disqualifying disposition and applies to both parties. It is important to note that exchanges between related parties may still use the tax-free benefits of §1031, provided the two-year waiting period and other requirements listed below are met (§1031(f) and (g)).

Who Is a Related Party?

Related parties include:

1. **Family members.** Brothers, sisters, spouse, ancestors and lineal descendants as well as C or S Corporations and over 50% shareholders, corporate controlled members, and grantors and fiduciaries of trusts (§267(b)).
2. **Partnership–partner.** The related party definition also includes over 50% partner-to-partnership attribution rules (§707(b)).

Exceptions Exist to the Two-year Rule

1. **Certain dispositions within two years of an exchange will not invalidate §1031 treatment (§1031(f)(2))**. This includes dispositions:

    a. after the earlier of the death of the taxpayer or the death of the related person;
    b. in an involuntary conversion if the exchange occurred before the threat or imminence of such conversion; and
    c. that the taxpayer can establish to the satisfaction of the Secretary that the exchange had as one of its principal purposes the avoidance of Federal income tax. The Conference Report gives three examples of this non-tax-avoidance exception: (1) transactions involving certain exchanges of undivided interests in different properties that result in each taxpayer's holding either the entire interest in a single property or a larger undivided interest in any of the properties; (2) dispositions of property in non recognition transactions (e.g., §1033); and (3) transactions that do not involve the shifting of basis between properties.

2. **If risk of loss is diminished (§1031(g)).** The running of the two-year holding period will be suspended during any period when a party's risk of loss with respect to the property is substantially diminished, such as: (1) the holding of a put with respect to the property; (2) the holding by another person of a right to acquire the property; or (3) a short sale or any other transaction.

> ***Example.*** Dan and George, who are brothers, exchange like-kind property in a §1031 transaction. The realized gain on the exchange is postponed. Dan sells the property he received 18 months after the exchange. The result is that an unqualified like-kind exchange is deemed to have occurred—as of the date Dan sold the property. When Dan disposes of the property, it causes all of the postponed gain to be recognized as of the date of the disposition. Not only does Dan have to recognize the gain, but George also has to recognize the gain he postponed.
>
> What happens if Dan, 18 months after the exchange, enters into another §1031 exchange with an unrelated party? Even in this case, the second §1031 exchange is treated as a sale and will cause Dan and George to recognize the postponed gain from the first exchange.

Tax planning tip: Therefore, advance tax planning is required. Strong controls must exist between the related parties to prevent unexpected tax consequences created by the unilateral actions of just one of the parties. The legal documents should include a provision specifying that if either of the parties triggers the recognition of the postponed gain within the two-year period, the innocent party will be reimbursed for the tax consequences.

Related Parties Who Exchange Must File IRS Form 8824 for the Next Two Years!

If the exchange is made with a related party, the taxpayer must file Exchange Form 8824 in the year of the exchange *and for the two following years* (Tax Management, Inc. (BNA) Portfolio, Vol. 61-5th, page C&A-2, A-31).

Don't Acquire Replacement Property from Related Party in Deferred Exchange!

Substance over form, not taxpayer intent, is deciding factor. Commercial real estate developer Ocmulgee Fields, Inc. (OFI), a Georgia corporation, agreed to sell real estate, Wesleyan Station Shopping Center, to an unrelated party for $7,250,000. OFI's basis in Wesleyan Station was $716,000, and, after selling expenses, OFI realized a gain of $6,123,000. In anticipation of completing a like kind exchange, OFI contracted with Security Bank of Macon Georgia to serve as a qualified intermediary. OFI transferred Wesleyan Station to Security Bank, who, on Oct. 10, 2003, completed the sale of Wesleyan Station to the unrelated party.

OFI originally intended to purchase replacement property from an unrelated party; however, it was unable to find suitable replacement property within the 45 day replacement period. OFI did, however, timely identify the Rivergate commercial property as replacement property. The Rivergate property was owned by Treaty Fields LLC, a related party to OFI as defined by §1031(f)(3). Security Bank completed the purchase and transfer of the Rivergate property from Treaty Fields within the requisite time constraints of §1031.

Even though OFI sold the Wesleyan Station property to an unrelated third party, the court found that the transaction was economically equivalent to a direct exchange of the Wesleyan Station and Rivergate properties between OFI and Treaty Fields LLC, followed by the sale of the Wesleyan Station property by Treaty Fields LLC to the unrelated third party. The interposition of a qualified intermediary in this transaction, and the fact that OFI held the replacement Rivergate property for more than two years did not obscure the end result.

Basis shifting final blow to OFI's case. Once the court concluded that the transaction was essentially a sale of the exchanged property by a related party within two years, the only matter left to decide was whether or not an exception to the two year rule was met. OFI argued that the exchange did not have as one of its principal purposes the avoidance of Federal income tax. The court countered, and OFI conceded, that there was significant basis shifting between OFI and Treaty Fields LLC. Treaty Fields LLC's basis in the Rivergate property was $2,555,000 and it recognized a gain of $4,186,000 from the sale to OFI. OFI's basis was only $716,000 and the related gain was $6,123,000. Because the recognized gain would have been reduced by $1,937,000 to the related parties due to the shift in basis, the court concluded that the transaction was structured to avoid the purposes of §1031(f) and, consequently, OFI was not entitled to defer the gains that it realized on the exchange of the Wesleyan Station property (***Ocmulgee Fields, Inc. v. Comm.***, 132 TC No. 6, March 31, 2009**;** see also ***Teruya Brothers, Ltd. & Subsidiaries v. Comm.***, 124 TC–, No. 4, February 9, 2005).

> **Note**: The real risk of "playing the audit lottery" is that both sales are now taxable. In the above case, OFI is not allowed §1031 deferred tax treatment, resulting in taxable income of $6,123,000. In addition, Treaty Fields, LLC still has to recognize the gain of $4,186,000 from the sale of its Rivergate property. Quite a nasty tax result!

Section 121 and Section 1031 on The Same Property

Rev. Proc. 2005-14 provides guidance as to when a homeowner may benefit from both the §121 home-sale exclusion and a §1031 like-kind deferral. In such cases, the property must have been used consecutively or concurrently as a home and a business. A taxpayer who uses a portion of a property for residential purposes and a portion of the property for business purposes is treated as using the entire property as the taxpayer's principal residence for purposes of satisfying the 2-year use requirement if the residential and business portions of the property are within the same dwelling unit (§1.121-1(e)).

Computation of Gain

For exchanges meeting the requirements of both §121 and §1031:

1. **Apply sale-of-home rules before like-kind exchange rules.** The §121 exclusion must be applied to gain from the exchange before the application of §1031; that is, for

purposes of determining gain that may be deferred under §1031, the §121 exclusion should be applied first against amounts received by the taxpayer that are not reinvested in the replacement property (amounts equivalent to boot that would result in gain recognition absent the application of §121) (Rev. Proc. 2005-14 Sec. 4.02(1));

2. **Depreciation recapture.** The §121 exclusion does not apply to gain attributable to depreciation deductions for periods after May 6, 1997, claimed with respect to the business or investment portion of a residence (§121(d)(6). However, §1031 may apply to such gain (Rev. Proc. 2005-14 Sec. 4.02(2));
3. **Treatment of boot.** In applying §1031, cash or other non-like kind property (boot) received in exchange for property used in the taxpayer's trade or business or held for investment (the relinquished business property) is taken into account only to the extent the boot exceeds the gain excluded under §121 with respect to the relinquished business property (Rev. Proc. 2005-14 Sec. 4.02(3)); and
4. **Computation of basis.** In determining the 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. Thus, under §1031(d), the basis of the replacement business property is increased by any gain attributable to the relinquished business property that is excluded under §121 (Rev. Proc. 2005-14 Sec. 4.03).

Examples of Exchanges Meeting the Requirements of Both §121 and §1031

***Example.*- Principal residence converted to rental and then sold.** Karen buys a house for $210,000 that she uses as her principal residence from 2001 to 2005. From 2005 until 2007, Karen rents the house to tenants and claims depreciation deductions of $20,000 for the entire period. In 2007, Karen exchanges the house for $10,000 of cash and a townhouse with a fair market value of $460,000 that she intends to rent to tenants. Karen realizes gain of $280,000 on the exchange.

Amount realized:	$470,000
Less: Adjusted Basis:	$190,000
Realized Gain:	$280,000
Less: Gain excluded under §121:	$250,000
Gain to be deferred under §1031:	$ 30,000

Because Karen owns and uses the house as her principal residence for at least two years during the five-year period prior to the exchange, she may exclude gain under §121. Because the house is rental property at the time of the exchange, she may also defer gain under §1031. Karen first applies §121 to exclude $250,000 of the $280,000 gain before applying the nonrecognition rules of §1031 . Karen may additionally defer the remaining gain of $30,000, including the $20,000 gain attributable to depreciation, under §1031. Although she receives $10,000 of cash (boot) in the exchange, Karen is not required to recognize gain because the boot is taken into account for purposes of §1031(b) only to the extent the boot exceeds the amount of excluded gain under §121 (Rev. Proc. 2005-14, Sec. 5, Exp. 1).

Comment: In other words, the entire boot received is considered to be gain excludable under the sale-of-home rules as it didn't exceed the $250,000 exclusion amount. What a great deal!

Example. **Sale of principal residence with separate office building.** Sharon buys property for $210,000, consisting of two separate dwelling units, a house and a guesthouse. From 2002 until 2007, Sharon uses the house as her principal residence and uses the guesthouse as an office in her trade or business. Based on the square footage of the respective parts of the property, Sharon allocates 2/3 of the basis of the property to the house and 1/3 to the guesthouse.

In 2007, Sharon exchanges the entire property for a residence and a separate property that she intends to use as an office. The total fair market value of Sharon's replacement properties is $360,000 with the replacement residence being valued at $240,000 and the business property valued at $120,000 (which is equal to the fair market value of the relinquished business property). From 2002 to 2007, Sharon claims depreciation deductions of $30,000 for the business use and realizes a gain of $180,000 on the exchange.

	Total	2/3:home	1/3:office
Amount realized	$360,000	$240,000	$120,000
Basis	$210,000	$140,000	$ 70,000
Depreciation adjustment	$ 30,000		$ 30,000
Adjusted basis	$180,000	$140,000	$ 40,000
Realized gain	$180,000	$100,000	$ 80,000
Gain excluded under §121	$100,000	$100,000	
Gain deferred under §1031	$ 80,000		$ 80,000

Under §121, Sharon excludes gain of $100,000 allocable to the residential portion of the house because she meets the ownership and use requirements for that portion of the property. Because the guesthouse is business property separate from the dwelling unit and Sharon has not met the use requirements for the guesthouse, she may not exclude the gain allocable to the guesthouse under §1.121-1(e). However, because the fair market value of the replacement business property is equal to the fair market value of the relinquished business property and she receives no boot, Sharon may defer the remaining gain of $80,000 under §1031.

Because no portion of the gain attributable to the relinquished business property is excluded under §121 and Sharon receives no boot and recognizes no gain or loss in the exchange, Sharon's basis in the replacement business property is equal to her basis in the relinquished business property at the time of the exchange ($40,000). Of course, Sharon’s basis in the replacement residential property is the fair market value of the replacement residential property at the time of the exchange ($240,000) (Rev. Proc. 2005-14, Sec. 5, Exp. 2).

Example. **Sale of principal residence and office in same dwelling unit.** If, in the previous example, Sharon had purchased a single dwelling unit which contained her office, because §121 applies before the nonrecognition rules of §1031, Sharon may exclude $50,000 of the gain allocable to the office. Sharon may not exclude under §121 that portion of the gain ($30,000) attributable to depreciation deductions, but may defer it under §1031.

	Total	2/3:home	1/3:office
Amount realized	$360,000	$240,000	$120,000
Basis	$210,000	$140,000	$ 70,000
Depreciation adjustment	$ 30,000		$ 30,000
Adjusted 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

Sharon’s basis in the replacement business property is $90,000, which is equal to her 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) (see Rev. Proc. 2005-14, Sec. 4.03) (Rev. Proc. 2005-14, Sec. 5, Exp. 3).

Example. **Gain in excess of exclusion can be deferred.** When the total fair market value of the replacement properties is $540,000, Sharon may exclude the gain of $220,000 allocable to the residential portion of the house under §121. The remaining $140,000 gain allocable to the business portion of the house, which is also nontaxable as she may first use any remaining exclusion ($30,000), followed by deferring the remaining $110,000 under §1031 (see Rev. Proc. 2005-14, Sec. 4.02(1).

	Total	2/3:home	1/3:office
Amount realized	$540,000	$360,000	$180,000
Basis	$210,000	$140,000	$ 70,000
Depreciation adjustment	$ 30,000		$ 30,000
Adjusted basis	$180,000	$140,000	$ 40,000
Realized gain	$360,000	$220,000	$140,000
Gain excluded under §121	$250,000	$220,000	$ 30,000
Gain deferred under §1031	$110,000		$110,000

Sharon's basis in the replacement business property is $70,000, which is equal to her basis in the relinquished business property ($40,000), increased by the amount of the gain excluded under §121 ($30,000) (see Rev. Proc. 2005-14, Sec. 4.03) (Rev. Proc. 2005-14, Sec. 5, Exp. 4).

Example. **But too much residential gain may create taxable income.** If the total fair market value of the replacement properties is increased to $750,000, $110,000 of the gain becomes taxable, i.e., the excess gain associated with the principal residence.

	Total	2/3:home	1/3:office
Amount realized	$750,000	$500,000	$250,000
Basis	$210,000	$140,000	$ 70,000
Depreciation adjustment	$ 30,000		$ 30,000
Adjusted basis	$180,000	$140,000	$ 40,000
Realized gain	$570,000	$360,000	$210,000
Gain excluded under §121	$250,000	$250,000	
Gain deferred under §1031	$210,000		$210,000
Gain recognized	$110,000	$110,000	

Sharon's basis in the replacement business property is $40,000, which is equal to her basis in the relinquished business property at the time of the exchange.

Qualified Exchange Accommodator Participation

The use of a qualified accommodator prevents the taxpayer from constructively receiving the money from the sale of the relinquished property in a tax-deferred exchange. The IRS has announced that both simultaneous and deferred exchanges are permitted (but not required) to be facilitated by the use of a qualified intermediary if the exchanger's rights to receive the money or other property held by the accommodator are substantially limited or restricted. In this case the qualified accommodator is not considered the agent of the taxpayer (an agent is normally a disqualified person). The accommodator may actually purchase the property (even from money advanced directly by the exchanger) and then effect an exchange or simply assign the contractual right to purchase the property desired (see above discussion on direct deeding) (§1.1031(k)-1(g)(4)(i)&(vi)).

Relief for Delayed Exchange Participants with Bankrupt Qualified Intermediaries

LandAmerica 1031 Exchange Services, Inc., a qualified intermediary, filed for bankruptcy protection at a time when it held $420 million for 450 customers who had deposited funds in anticipation of acquiring replacement property to complete their exchange.

What happens to the hapless taxpayer who cannot complete his §1031 exchange because of the bankruptcy of the qualified intermediary? It certainly looked like a big tax bill would result until the IRS stepped in with its new Revenue Procedure 2010-14.

Qualifying taxpayer. A new safe harbor applies for delayed exchanges if the taxpayer (1) identified replacement property, (2) did not complete the like-kind exchange solely because the qualified intermediary defaulted when the QI became subject to a bankruptcy proceeding or a receivership, (3) did not have actual or constructive receipt of the proceeds from the disposition of the relinquished property.

No gain recognized until payment received. If the QI defaults on its obligation to acquire and transfer replacement property, gain is recognized as the taxpayer receives payments attributable to the relinquished property using a safe harbor gross profit ratio.

Safe harbor gross profit ratio method. Under the safe harbor gross profit ratio method, the portion of any payment attributable to the relinquished property that is recognized as gain is determined by multiplying the payment by a fraction, the numerator of which is the taxpayer's gross profit and the denominator of which is the taxpayer's contract price.

Example. Karen owns investment property (Property 1) with a fair market value of $150,000 and an adjusted basis of $50,000. Karen enters into an agreement with Fast Exchange Inc., a qualified intermediary, to facilitate a deferred like-kind exchange. On May 6, 2010, Karen transfers Property 1 to Fast Exchange Inc. and it transfers the property to a third party in exchange for $150,000. Karen intends that the $150,000 held by her qualified intermediary be used to acquire her replacement property. On June 1, 2010, Karen identifies Property 2 as replacement property. On June 15, 2010, Fast Exchange Inc. notifies Karen that it has filed for bankruptcy protection and cannot acquire replacement property. Consequently, Karen fails to acquire Property 2 or any other replacement property within the exchange period. As of December 31, 2010, Fast Exchange Inc.'s bankruptcy proceedings are on-going and Karen has received none of the $150,000 proceeds from the intermediary or any other source. On July 1, 2011, Fast Exchange Inc. exits from bankruptcy and the bankruptcy court approves the trustee's final report, which shows that Karen will be paid $130,000 in full satisfaction of Fast Exchange Inc.'s obligation under the exchange agreement. Karen receives the $130,000 payment on August 4, 2011.

Because of this revenue procedure, Karen is not required to recognize gain in 2010 because she did not receive any payments attributable to the relinquished property in 2010. She recognizes gain in 2011. Karen's selling price is $130,000 (the payment received during the year.) Karen's contract price also is $130,000 because there is no satisfied or assumed indebtedness. Her gross profit is $80,000 (the selling price ($130,000) minus the adjusted basis ($50,000)). Karen's gross profit ratio is 80/130 (the gross profit over the contract price). She must recognize gain in 2011 of $80,000 (the payment attributable to the relinquished property ($130,000) multiplied by her gross profit ratio (80/130)). Furthermore, even though the payment attributable to the relinquished property ($130,000) is less than the $150,000 proceeds received by the intermediary, Karen is not entitled to a §165 loss deduction because the payment exceeds her adjusted basis in the relinquished property ($50,000).

Interest Income

Individuals and entities performing services as §1031 exchange facilitators (EF) (qualified intermediaries (QI)) are typically paid for their services by either: (1) establishing a set fee, payable by the taxpayer; or, (2) by keeping all amounts earned on exchange funds while such funds are in the custody of the exchange facilitator. The final regulations clarify that, for like-kind exchange transactions entered into on or after October 8, 2008, the tax treatment of earnings on escrow or trust accounts held by an exchange facilitator/qualified intermediary varies considerably depending on which method of payment is used:

1. **If the EF/QI has a right to retain the earnings from the deposited funds**, the taxpayer is treated as the owner of the exchange funds which are treated as loaned from the taxpayer to the EF/QI. The EF/QI reports any investment earnings from the

exchanged funds on its tax return. Interest is required to be imputed on the deemed loan between the taxpayer and the EF/QI.

2. **If the taxpayer has the right to receive any investment earnings** from the deposited funds, the taxpayer is treated as the owner of the funds and the earnings. The taxpayer reports any investment earnings on his or her tax return and the EF/QI has no additional reporting (T.D. 9413; §§1.468B-6, 1.7872-5(b)(16), 1.7872-16).

Exchange funds are generally to be treated as loans to an exchange facilitator or qualified intermediary (EF/QI) (§1.468B-6(c)(1). For taxpayers who transfer exchange funds (property, cash or cash equivalents) to qualified escrow or trust accounts, and all earnings attributable to the exchange funds are kept by the EF, the transferred funds are treated as an "exchange facilitator loan" from the taxpayer to the EF/QI. For such "loans", the EF must take into account all items of income, deduction, and credit (including capital gains and losses) attributable to the exchange funds.

Below market rate loan rules apply to exchange facilitator loans - Special AIR applies (§1.7872-16). An exchange facilitator loan is a compensation related demand loan to which the below market rate loan rules under §7872 apply. For purposes of imputing interest, the applicable Federal rate is the lower of the short-term AIR in effect as of the day on which the loan is made, compounded semiannually, or the 91-day rate. The 91-day rate is equal to the investment rate on a 13-week (generally 91-day) Treasury bill with the same issue date as the date that the loan is made or, if the two dates are not the same, with an issue date that most closely precedes the date loan is made (§1.468B-6(d)). The Treasury bill rates can be found at www.treasurydirect.gov/RI/OFBills.

Example. On December 1, 2010, Vern transfers relinquished property to Ron, who in turn transfers cash of $2,100,000 to QI, a qualified exchange facilitator. Vern enters into an exchange agreement with QI that specifies that QI will keep all investment earnings from the $2,100,000 while it is held in QI's custodial account. QI will not charge any additional fee to Vern for services provided. QI deposits the $2,100,000 into a money market account. On March 1, 2011, QI uses the $2,100,000 to purchase replacement property and transfers the property to Vern.

The exchange funds held by QI are treated as loaned to QI from Vern under §1.468B- 6(c)(1). The amount loaned is $2,100,000 and the loan is outstanding for three months. Vern uses the short term AIR, which is 4 percent, compounded semi-annually, to impute interest. The amount of forgone interest on the loan for 2010 is $7,000 ($2,100,000 x 4% /12 months x 1 month). The amount of forgone interest for 2011 is $14,000 ($2,100,000 x 4% /12 months x 2 months). The $7,000 for 2010 is deemed transferred as compensation by Vern to QI and then retransferred as interest by QI to Vern on December 31, 2010. Vern will report interest income on his 2010 return of $7,000 and QI will report service income of the same amount. The 2011 amount of $14,000 is deemed transferred as compensation by Vern to QI and then retransferred as interest paid by QI to Vern on March 1, 2011.

Phantom income is the result! In this example, Vern will report interest income of $21,000 and deduct 1031 exchange fees of $21,000. The problem is that the interest income is immediately taxable, whereas the exchange fees are capitalized and depreciated, assuming depreciable property is acquired, over 27.5 or 39 years. Taxpayers (or their advisors) would be foolish to consider such an agreement that subjects the taxpayer to phantom income of $21,000.

Exception from the below market rate loan rules are allowed for some exchange facilitator loans (§1.7872-16(f)). An exchange facilitator loan is exempt from the below market rate loan rules of §7872 if:

1. The amount of the exchange funds treated as loaned does not exceed $2,000,000; and
2. The duration of the loan is 6 months or less.

If the above exception applies, then there is no imputed interest or fees associated with the exchange facilitator loan. The rules of §7872 are simply ignored.

Exchange funds not treated as loaned to an exchange facilitator if earnings paid to taxpayer (1.468B-6(c)(2)). If, in accordance with an escrow or exchange agreement, all the earnings attributable to a taxpayer's exchange funds are paid to the taxpayer, exchange funds are not treated as loaned from the taxpayer to an exchange facilitator. Instead, the taxpayer takes into account all items of income, deduction, and credit (including capital gains and losses) attributable to the exchange funds.

Taxpayers must be able to document that all earnings on the exchange funds are paid to them. Otherwise, the exchange funds will be treated as a loan to the EF. Earnings attributable to the taxpayer's exchange funds are considered paid to the taxpayer:

1. If an exchange facilitator holds all of the taxpayer's exchange funds in a separately identified account, and, all of the earnings credited to that account are deemed 100% attributable to the taxpayer's exchange funds. In general, a separately identified account is an account established under the taxpayer's name and taxpayer identification number with a depository institution. Sub-accounts may be treated as a separately identified account if the master account under which the sub-account is created is established with a depository institution, the depository institution identifies the sub-account by the taxpayer's name and taxpayer identification number, and the depository institution specifically credits earnings to the sub-account.
2. If an exchange facilitator commingles (for investment or otherwise) the taxpayer's exchange funds with other funds or assets, all earnings attributable to the commingled funds that are allocable on a pro-rata basis (using a reasonable method that takes into account the time that the exchange funds are in the commingled account, actual rate or rates of return, and the respective account balances) to the taxpayer's exchange funds must be paid to the taxpayer.

3. If any payment made from the taxpayer's exchange funds, or from the earnings attributable to the taxpayer's exchange funds, for a transactional expense of the taxpayer (i.e., EF/QI fees) is first treated as paid to the taxpayer and then paid by the taxpayer to the recipient.