The Interplay Between Section 121 and Section 1031

How to Sell and Exchange Real Estate
and
Never Pay Income Tax

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Introduction

The Taxpayer Relief Act of 1997 (the "Act") enacted new Section 121 to replace the prior rollover and one-time exclusion provisions under Section 1034 and old Section 121. Section 121 now provides for an exclusion of gain from the sale or exchange of a principal residence of up to $250,000 (single individual or eligible spouse) or $500,000 (certain joint returns). The property must be owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating 2 years or more during the 5-year period ending on the date of the sale or exchange. The exclusion can be used only once every 2 years (although a partial exclusion may be available in certain cases). There is no reinvestment requirement in another principal residence.

Use of the exclusion may dramatically increase a taxpayer's wealth over time without payment of any income tax. For example, suppose the taxpayer and his wife own or acquire a 4-unit condominium building that has $2 million in gain. They move into Unit #1, live there for 2 years and exclude up to $500,000 in gain on the sale. Then they move into Unit #2, live there for 2 years and exclude up to $500,000 in gain on that sale. They repeat the process for Unit #3 and Unit #4. In 8 years, the taxpayer and his wife exclude $2,000,000 in gain from the sale of the condominium building and pay no income tax thereon. Over 40 years, they could exclude up to $10 million in gain by becoming "serial" home sellers. The tax savings are even more staggering when an entire family of children and their spouses and grandchildren take part.

This article focuses on the significant tax break provided under Section 121 and its interplay with Section 1031 exchanges. As discussed in Part II below, the two provisions are no longer mutually exclusive. For example, assume that a property has been used as a principal residence for 2 years and then rented out for 2 years. The taxpayers could sell or exchange the property in the fifth year and, in effect, elect whether Section 121 or Section 1031 will apply to the transfer. If the property is exchanged, both the Section 121 exclusion and Section 1031 nonrecognition treatment may apply. Both provisions also come into play in cases of mixed-use property where only part of the property is used as the taxpayer's principal residence.

One of the most significant "interplays" is the conversion of investment property after a Section 1031 exchange into the taxpayer's principal residence. The taxpayer and his wife live there for 2 years and then sell the property and exclude up to $500,000 in gain. In the example above, the

taxpayers could have acquired the condominium building in a prior Section 1031 exchange, rented the building out for a period of time (e.g., 2 years), and then converted the property to their principal residence unit-by-unit. Such transactions should succeed under the new tax law as long as the prior Section 1031 exchange is not disqualified. See Part III below.

Another interplay involves the conversion of a principal residence into investment property in anticipation of a future Section 1031 exchange. For example, if there are millions of dollars of gain in the principal residence, the taxpayer may not be content with excluding only $250,000 or $500,000 of gain under Section 121. He cannot defer the gain into a more expensive residence since Section 1034 was repealed. The taxpayer therefore converts the principal residence into investment property by renting it out at fair market value for a period of time (e.g., 2 to 3 years). Then he can defer recognition of the gain by exchanging the property for other investment property under Section 1031. He may be able to "eat his cake too" if the exchange qualifies for the Section 121 exclusion of gain and the balance of the gain may be deferred under Section 1031. Such transactions should succeed as long as the property qualifies under Section 1031 at the time of the exchange. See Part III below.

In cases of mixed-use property, an allocation must be made between the part of the property used as the taxpayer's principal residence and the part used for business or investment purposes (e.g., a qualified home office, a farm, rental units or land held for investment). In these cases, Section 121 may apply to the portion of the property used as the taxpayer's principal residence, thereby excluding up to $250,000 or $500,000 in gain on that part. The balance of the property used for business or investment purposes could be exchanged for like-kind property under Section 1031. A comprehensive example is set forth in Part IV. The case study involves a principal residence and excess land held for investment purposes.

Section 121 is likely to take a high position in the tax advisor's bag of tricks. It should be ready-to-hand next to, and sometimes joined with, Section 1301. As suggested by our title and the examples above, this article concerns the aggressive use of Sections 121 and 1031 to avoid paying income tax on the disposition of residential real estate. But since commercial property and unimproved land may be exchanged for residential real estate under Section 1031, the article really concerns any real estate whatsoever.

For the aggressive use of Section 121 and 1031 to succeed, however, the specific requirements of Sections 121 and 1031 must be met. Part II focuses on these requirements. Part III addresses conversions of property (from investment property to a principal residence of vice versa). Part IV concerns mixed-use property (including a detailed example). Part V discusses related party transactions. We conclude that, with proper planning and adherence to the requirement of Sections 121 and 1031, the transactions presented above (and their many variations) should in fact produce the desired tax savings.

II. Section 121 Requirements

This part analyzes the requirements of Sections 121 and 1031 insofar as they related to the interplay issue, including the examples above. In particular, we address what it means for property to be the taxpayer's "principal residence" under Section 121, what counts as ownership and use for 2 out of 5 years, and special rules relating to the partial exclusion, the recognition of gain attributable to depreciation after May 6, 1997, and the election not to have the exclusion apply.

With respect to Section 1031, we discuss what it means for property to be held for "investment," and how long the relinquished or replacement property in an exchange must be "held" for a qualified use. We do not address the other requirements of Section 1031, including the "exchange" requirements and other rules. We shall see that the statutory requirements of both Section 121 and Section 1031 may be met for the same property having different uses at different times, and for mixed-use property having different uses at the same time.

A. **Purpose of Section 121**. The statute and legislative history are set forth in the Appendix. Congress enacted Section 121 for several reasons. First, Congress desired to minimize the record-keeping burdens for capital improvements and associated issues (repairs versus improvements) for most taxpayers when selling their home. Second, Congress wanted to avoid the "inefficient use of financial resources" caused by the purchasing of larger and more expensive homes under the old rollover rules. Third, Congress intended to allow more taxpayers to sell their homes freely and remove a constraint on the mobility of the elderly. Finally, Congress sought to put an end to several traps for the unwary under the old rules (e.g., marrying a person who previously used the one-time exclusion, recognition of gain when moving from a high cost housing area to a low cost area, and

traps for divorcing couples). The stature achieves these objectives by enacting a fairly generous exclusion ($250,000 per qualified person), eliminating the rollover requirement under Section 1034, and liberalizing the rules for spouses and ex-spouses. However, the record-keeping burden and issue of repairs versus capital improvements will remain for persons (a) over the exclusion limit, (b) with mixed-use property (including a qualified home office), or (c) who convert the residence to investment property.

B. **Principal Residence**. The statute does not define what constitutes the taxpayer's "principal residence." The legislative history also does not explicitly refer to or adopt prior case law or the regulations under Section 1034 concerning this matter. But this was simply taken for granted. There is nothing in the statute or legislative history to suggest that Congress intended to change the definition of "principal residence" as that term had been used and construed under Section 1034 and old Section 121. Further, in Publication 523 ("Selling Your Home"), the Service has indicated that the term means what it used to mean.

The regulations under Section 121 presumably will be amended to take into account other provisions of the Act. But the term "principal residence" is likely to continue to be defined by reference to the regulations under repealed Section 1034, or inserted directly into new regulations under Section 121. See Treas. Reg. Section 1.121-3(a). To interpret what constitutes the taxpayer's "principal residence" under Section 121, we have the regulations under old Section 121 (which presumably remain in effect until changed). We also have the prior cases, rulings and regulations under Section 1034 and old Section 121. These authorities should be considered "substantial authority" on this issue.

Treas. Reg. Section 1.1034-1(c)(3) defines property used by the taxpayer as his principal residence as follows:

"(i) Whether or not property is used by the taxpayer as his residence, and whether or not property is used by the taxpayer as his principal residence (in the case of a taxpayer using more than one property as a residence), depends upon all the facts and circumstances in each case, including the good faith of the taxpayer. The mere fact that property is, or has been, rented is not determinative that such property is not used by the taxpayer as his principal residence. . . . Property

used by the taxpayer as his principal residence may include a houseboat, a house trailer, or stock held by a tenant-stockholder in a cooperative housing corporation . . . .[It] does not include personal property such as a piece of furniture, a radio, etc., which, in accordance with applicable law, is not a fixture.

(ii) Where part of a property is used by the taxpayer as his principal residence and part is used for other purposes, an allocation must be made to determine the application of this Section. If the old residence is used only partially for residential purposes, only that part of the gain allocable to the residential portion is not to be recognized under this Section . . . ."

Three issues arise here: (a) whether the property is the taxpayer's residence, (b) if so, whether it is his principal residence and (c) if so, whether the property is also used for other purposes.

1. **Residence**. Property is a "residence" of the taxpayer only when the taxpayer himself occupies the property and uses it as a place to live. In Stolk v. Commissioner, 40 T.C. 345 (1963), aff'd 326 F.2d 760 (2d Cir. 1964), the court gave the term "residence" its ordinary meaning as the "place where one actually lives or has his home." The court went on to explain how a residence is acquired and how it is lost. Citing other cases, the court stated:

"It (residence) does not mean one's permanent place of abode, where he intends to live all his days, or for an indefinite or unlimited time; nor does it mean one's residence for a temporary purpose, with the intention of returning to his former residence when that purpose has been accomplished, but means, one's actual home, whether he intends to reside there permanently, or for a definite or indefinite length of time.

The elements of residence are the fact of abode and the intention of remaining, and the concept of residence is made up of a combination of acts and intention. Neither bodily presence alone nor intention alone will suffice to create a residence.

Residence has been defined to be a place where a person's habitation is fixed, without any present intention of removing therefrom. It is lost by leaving the place where one has acquired a permanent home and removing to another place animo non revertendi." (Citations omitted.) The

Ninth Circuit also adopted this definition of "residence" in Perry v. Commissioner, 91 F.3d 82 (9th Cir. 1996).

The taxpayer in Stolk did not meet the residence test after he moved out of the house with the intention of not living there again. The court distinguished cases in which the taxpayer did not occupy the property at the time of sale, including cases where the property was temporarily rented out before sale. The court found the facts to be significantly different than Trisko, infra and similar cases. In Stolk, the taxpayer never occupied or used his old residence for 2 years before its sale, moved all of his personal furniture into storage, rejected "a very attractive offer" within 2 days after listing the property for sale, and then left the house vacant without any efforts to market or sell it. Although the property was not rented out, converted to any business use or held for the production of income, the court determined that it was still not the taxpayer's principal residence. The court stated: "The phrase 'used by the taxpayer as his principal residence' means habitual use of the old residence as the principal residence. The antithesis is nonuse of property as the principal residence." Stolk, supra at 355.

The legislative history of Section 1034 also differentiates between a residence and business or investment property. "The term 'residence' is used in contradistinction to property used in trade or business and property held for the production of income. Nevertheless, the mere fact that the taxpayer temporarily rents out either the old or the new residence may not, in light of all the facts and circumstances in the case, prevent the gain from being "not recognized. " H. Rep. No 82-586 at 109 (1951), 1951-2 C.B. 357, 436; S. Rep. No. 82-781, Part 2, at 32 (1951), 1951-2 C.B. 545, 566.

The definition of a "residence" is important in several ways. First, certain sales of land without the dwelling will not be covered under Section 121. See, e.g., Rev. Rul. 56-420, 1956-2 C.B. 519 (gain recognized where portion of lot sold was used only for garden, orchard and chicken yard and did not include taxpayer's dwelling); O'Barr v. Commissioner, 44 T.C. 501 (1965) (part of property with dwelling not sold); Hughes v. Commissioner, 54 T.C. 1049 (1970), aff'd per curiam 450 F.2d 980 (4th Cir. 1971) (land sold after house moved to other land). Rev. Rul. 83-50, 1983-1 C.B. 41, modifying and revoking Rev. Rul. 54-156, 1954-1 C.B. 112 (same); Hale v. Commissioner T.C. Memo 1982-527 (land sold without house trailer). PLR 8220132 (February 23, 1982)

(subdividing lot and sale of vacant lot does not qualify for exclusion). Compare Bogley v. Commissioner, 263 F. 2d 746 (4th Cir. 1959), rev'g 30 T.C. 452 (1958) (nonrecognition provisions applied to sale of 10 acres of land where taxpayer previously sold residence and 3 acres of land surrounding it); Rev. Rul.76-541, 1976-2 C.B. 246 (sale of house on one parcel and sale of contiguous parcel in same year both qualified under Section 1034 since both parcels were used as taxpayer's principal residence); PLR 8817015 (subdividing property into lot with house and vacant lot, and their separate sales within the rollover period qualified under Section 1034).

Second, the property must be capable of being lived in and occupied as a home. See, e.g., Vidaurre v. Commissioner, 1997-164 (property contained only a foundation and never served as residence); Bayley v. Commissioner, 35 T.C. 288 (1960) (party constructed new home was too incomplete to be habitable and taxpayer merely put some furniture in upstairs room that was walled off); Stanley v. Commissioner, 33 T.C. 614 (1959) (taxpayer did not live in old house); Elam v. Commissioner, 58 T.C. 238 (1972) aff'd per curiam 477 F.2d 1333 (6th Cir. 1973) (guest house was new residence, not main house which was not occupied); Rev. Rul. 76-216 1976-1 C.B. 220 (condominium unit not ready for occupancy in the replacement period); Lukan v. Commissioner (trailer attached to new residence under construction was residence); Skorniak v. Commissioner, T.C. Memo 1976-178 (taxpayers resided in house on adjacent lot during construction, and electric and gas services in new house not used).

Third, the taxpayer himself must occupy the property as a residence. In a variety of cases, taxpayers never received nonrecognition treatment under Section 1034 because they themselves did not own or use the property as a residence. See, e.g., Walsche v. Commissioner, T.C. Memo 1994-46 (business partnership rented and used property for business purposes, although taxpayer-partner lived in house's apartment); Young v. Commissioner, T.C. Memo 1985-127 (daughter's use of residence not attributed to taxpayer); United States v. Sheahan, 323 F.2d 383 (5th Cir. 1963) (daughter's token use of home not sufficient); Perry v. Commissioner, 91 F.3d 82 (9th Cir. 1996), aff'd T.C. Memo 1994-247 (taxpayer permanently vacated house pursuant to divorce settlement agreement 4 years before sale, and use by ex-spouse and minor children was not use by the taxpayer); Rev. Rul. 54-583, 1954-2 C.B. 159 (trust was separate taxpayer and did not qualify as a person who used the property as a residence, even though beneficiary lived there); Davies v.

Commissioner, 54 T.C. 170 (1970) (taxpayer paid rent for apartment she lived in and building was depreciated by Illinois land trust); Mitchell v. United States, 44 AFTR 2d 79-5735 (P.C. Ca. 1979) (sale of decedent's home by estate, even though heir lived with decedent).

2. **Main Residence**. If a taxpayer owns and uses more than one residence, the second issue arises: which property constitutes the taxpayer's principal residence. As noted in Stolk, supra, the term "principal" means "chief or main." IRS Publication 523 indicates that the main residence is the one the taxpayer lives in most of the time (or more time than any other residence). Thus, if the taxpayer lives most of the time in a rented city apartment and uses his house for weekends or holidays or for a summer home, the apartment is his principal residence, not the house. See Stolk, supra (apartment in New York was the home where taxpayer lived most of the time, where he returned from business and vacation trips, and which he used as his address on tax returns and for voting purposes; farm in Virginia was not principal residence, although household furnishings were moved there and taxpayer regularly spent weekends and holidays there); Friedman v. Commissioner, T.C. Memo 1982-178 (midtown rented apartment was principal residence while houses were used as summer homes); Bowers v. Commissioner, T.C. Memo 1996-333 (pre-marital Connecticut home was not principal residence where taxpayers purchased new residence and relocated husband's business to Florida); Evans v. Commissioner, T.C. Memo 1962-61 (neither property sold nor property acquired was principal residence since taxpayer voted and ran for office from another city where he lived during the week); PLR 8031070 (May 12, 1980) (U.S. Congressman's house in Washington D.C. is residence where he lived more than half of each year, and not house in his home state); PLR 8147065 (August 26, 1981) (main home was residence living in for 9 months of year, not city apartment used in winter months).

Like Section 1034 and old Section 121, new Section 121 is limited to the taxpayer's principal residence and does not apply to secondary residences, including vacation homes. By proper planning and scheduling, however, taxpayers may establish a property as their principal residence. See, e.g., Mitchell v. Commissioner, T.C. Memo 1997-493 (new residence established as principal residence when taxpayers moved in, put belongings there, changed mail delivery service, and connected telephone and other utilities, even though they stayed at other residence during heavy renovation construction); Thomas v. Commissioner, 92 T.C. 206 (1989) (Illinois house was

taxpayer's principal residence where he spent 50% of his time there and the other 50% in one of three other homes in Florida; taxpayer's business was located in Illinois, tax returns were filed there as full-time residents during the year before sale and as part-time residents during the year of sale, and wife was to vote, contributed to and attended church and had a driver's license in Illinois). See also. Rev. Rul. 78-146, 1978-1 C.B. 260 (taxpayer's principal residence is one which taxpayer intended to return to and reoccupy after 2-year assignment in another city, even though residence was leased for 2-year period and another residence purchased in the other city was also sold); Rev. Rul. 77-298, 1977-2 C.B. 308 (Washington D.C. residence of Congressman occupied by him and family the majority of time is principal residence, even though he retained house in home district and used it occasionally for lodging).

In deciding which place was the taxpayer's principal place of residence, the courts have taken into account such factors as: "(1) The amount of time spent at one residence as opposed to another; (2) whether the taxpayer abandoned the residence with the intent not to return and his nonuse of the property was substantial from the time he left the property; and (3) whether a temporary rental of a residence was necessitated because of an adverse real estate market as opposed to converting a residence into a nontemporary rental for the production of income." Thomas, supra at 244 (citing cases).

The foregoing factors are not exclusive but merely illustrates that all of the facts and circumstances of a particular case must be weighed. "In addition, what might appear as a relevant factor in one case may have no relevance in another case." Id. (citing Clapham v. Commissioner, 63 T.C. 505, 508-510 (1975)). This case law leaves open the possibility that a residence where the taxpayer spends most his time might not be his "principal residence" under Section 121. But such cases are likely to be very rare exceptions, rather the general rule.

3. **Mixed-use property**. Section 121 should apply only to the part of the property owned and used by the taxpayer as his principal residence. See Treas. Reg. Section 1.121-5(e) (if attorney uses part of residence as law office for a period in excess of 2 [now 3] years of the 5 years preceding the sale, gain on that portion is not excluded) this treatment is consistent with old Section 121 and the Section 1034 regulations and prior cases and rulings. The legislative history to Section

1034 also shows that Congress intended to confer nonrecognition treatment only with respect to personal residences and not to business property. The committee reports stated:

"Where the taxpayer's residence is part of a property also used for business purposes, as is the case of an apartment over a store building or a home on a farm, and the entire property is sold, the provisions. . . will apply only to that part of the property used as a residence, including the environs and outbuildings related to the dwelling but not to those relating to the business operations." H. Rep. No. 586, 82d Cong., 1st Sess., at 27 (1951), 1951-2 C.B. 378.

IRS Publication 523 indicates that the Service interprets Section 121 in this manner. Accordingly, gain will not be excluded under Section 121 on the portion of the property used for purposes other than a principal residence. The statute itself only applies to the property that is owned and used by the taxpayer as the taxpayer's principal residence.

These other purposes include a qualified home office during the year of sale (see Wigfall v. Commissioner, T.C. Memo 1982-171; Rev. Rul. 82-26, 1982-1 C.B. 114), a farm (see Lokan v. Commissioner, T.C. Memo (1979-380); Spivey v. Commissioner, 40 T.C. 1051 (1963); Estate of Campbell v. Commissioner, T.C. Memo 1964-83), a ranch (Reid v. United States, 24 AFTR 2d 69-5230 (D.C. Ca. 1969); Richards v. Commissioner, T.C. Memo 1993-422), horse boarding and breeding (Schlicter v. Commissioner, T.C. Memo 1997-37), rental property (Gowan v. Commissioner) T.C. Memo 1975-124; Aagaard v. Commissioner, 56 T.C. 191 (1971); PLR 8532094 (May 17, 1985), business property (Poague v. United States, 66 AFTR 2d 90-5823 (E.D. Va. 1990), aff'd by unpublished order (4th Cir. 1991), and excess land (Beckwith v. Commissioner, T.C. Memo 1964-254, including acreage under soil conservation contract, woods and marshland and area used for helicopter experiments).

Property held for business or investment purposes may be exchanged, however, under Section 1031. See Coupe v. Commissioner, 52 T.C. 394 (1969), acq. In result only 1970-1 C.B. xv (excess land and house on 2 acres exchanged); Sayre v. United States, 163 F. Supp. 495 (S.D. WV 1958) (farm and residence exchanged, and any reasonable allocation of sales price may be used); Rev. Rul. 59-229, 1959-2 C.B. 180 (exchange of farm lands, buildings and crops for like-kind property qualifies under Section 1031, while exchange of personal residence is treated as a separate

transaction under Section 1034). New Section 121 should not change these rules relating to mixed-use property. See, e.g., Pagliarulo v. Commissioner, 1994-506 (fact that taxpayer resided in one unit and rented out other two units did not disqualify property under 1034, although new residence was not purchased in time).

Certain other uses of property are disregarded, such as the use of part of a basement to store business tools and materials. See Grace v. Commissioner, T.C. Memo 1961-252 (no allocation required where business usage was insignificant). In addition, if the property is not used as a qualified home office in the year of sale, no allocation is required. See Rev. Rul. 82-26, supra; IRS Publication 523. Finally, land used for hiking, recreation and the enjoyment of open space may be considered used as the taxpayer's principal residence. See Schlicter, T.C. Memo 1997-37 (43 1/2 acres of land treated as part of principal residence); Bennett v. United States, 61-2 USTC Par. 9697 (N.D. Ga. 1961) (jury verdict that entire 65-acre tract on which taxpayer's house was situated constituted taxpayer's principal residence, rather than merely 2 1/2 acres as contended by the Government); Richards, T.C. Memo 1993-422 (27.6 acres of dry pasture and rangeland treated as part of residence, while 128.2 acres of irrigated land was part of business property). Compare Beckwith and Estate of Campbell, infra.

5. **Qualified Property**. The principal residence must be qualified property under Section 121. Such property includes a joint tenancy or a tenancy-in-common interest (Green v. Commissioner, T.C. Memo 1992-439; Rev. Rul. 67-234, 1967-2 C.B. 78; Rev. Rul. 67-235, 1967-2 C.B. 79) but does not include an interest in a partnership since the partnership would then own the property. See Walshe, supra; Allied Marine Systems, Inc. v. Commissioner, T.C. Memo 1997-201 (partnership, not partner, owned the house that was sold). But see PLR 8741066 (July 16, 1987) ("partnership" was not formed for business or investment purposes and individuals qualified under Section 121 and 1034). Section 1031 also permits an exchange of a tenancy-in-common interest (see Rev. Rul. 79-44, 1979-1 C.B. 265; Rev. Rul. 73-476, 1973-2 C.B. 300; PLRs 9609016 and 9525038), but not of an interest in a partnership. (See Section 1031(a)(2)(D); PLR 9741017 (July 10, 1997); PLR 9645005). If, for example, a brother and sister sell their jointly owned residence and each of them meets the requirements of Section 121, each is entitled to his or her own exclusion of gain with respect to the sale of the undivided interests. See Rev. Rul. 67-235, 1967-2 C.B. 79; PLR

8015127 (January 18, 1980). Joint ownership of highly appreciated property will be favored under Section 121 since each member of the family or group that lives in the property will have his or her own $250,000 exclusion.

At the election of the taxpayer, qualified property may include a remainder interest in the residence. See Section 121 (d)(8)(A). But Section 121 (d)(8)(A) also provides that Section 121 will not apply to any other interest in the residence which is "sold or exchanged separately." Presumably this includes a life estate, a term interest, an estate for years, a leasehold interest, an easement or even an undivided interest in the residence if the interest is "sold or exchanged separately." A taxpayer who sells a remainder interest must still meet all of the other requirements of Section 121. The provisions of Section 121(d)(8)(A) may supersede certain cases and rulings. See Ray v. Commissioner, T.C. Memo 1995-23 (sale of future interest to son subject to retained usufruct interest and second sale of other part of property did not qualify under old Section 121); PLR 8246123 (life estate holder did not qualify under old Section 121 because interest was only partial ownership, and remainder did not qualify because they had no right to possession and ownership of residence until termination of life estate); PLR 8029088 (April 25, 1980) (sale of remainder interest while reserving life estate was held not to constitute a disposition under old Section 121).

Section 121(d)(8)(B) provides that the above rule of Section 121(d)(8)(A) shall not apply to any sale to, or exchange with, a related person (determined by reference to Sections 267(b) and 707(b)). Presumably this means that a remainder interest in the residence cannot be sold to or exchanged with a related person under Section 121.

Rev. Rul. 84-43, 1984-1 C.B. 27, held that Section 121 applies to the sale of a life estate if the life estate is the taxpayer's entire (legal and equitable) interest in the residence, and that it is not necessary that the taxpayer own the entire fee interest. A 25-year assignable term interest was held to qualify under Section 1034 where it represented the taxpayer's entire interest in the property. The taxpayers sold the property to the government and retained the 25-year term estate 7 years before the sale of the interest. See PLR 8607034 (November 18, 1985). No opinion was expressed in the ruling, however, as to whether the residence was the taxpayer's principal residence since they rented the house for 3 years while trying to sell the interest.

Granting a new lease of life estate, while retaining the reversionary interests, may not be a sale or exchange of property under Section 121. In several Section 1031 cases and rules, these transactions resulted in the receipt of advance rental income. See Pembroke v. Helvering, 23 B.T.A. 1176 (1931), aff'd 70 F.2d 850 (D.C. Cir. 1934) (owner who executes a 99-year lease in exchange for fee in other property receives advance rental income); Rev. Rul. 66-209, 1966-2 C.B. 299 (same). If a pre-existing leasehold or life estate is the only interest owned by the taxpayer in the residence, the interest may be sold or exchanged under Section 121. See Rev. Rul. 84-43, supra. But see Boesel v. Commissioner, 65 T.C. 378 (1975) (court found significant differences between outright ownership and leasehold interest with 73-year term under Section 1034); Rev. Rul. 72-266, 1972-1 C.B. 227 (same). Compare Treas Reg. Section 1.1031(a)-1(c) (pre-existing leasehold interest may be exchanged under Section 1031); Rev. Rul. 68-394, 1968-2 C.B. 338 (leasehold interest may be acquired under Section 1033).

Qualified property includes a residence in a foreign country) (Rev. Rul. 54-611, 1954-2 C.B. 159; Rev. Rul. 71-495, 1971-2 C.B. 311) and a residence in a U.S. territory (Bergersen v. Commissioner, T.C. Memo 1995-424). However, Section 121 does not apply to expatriates subject to the provisions of Section 877(a)(1). See Section 121(e).

Qualified property includes stock as a tenant-shareholder in a cooperative housing corporation under Section 121(d)(4). See also Rev. Rul. 60-76, 1960-1 C.B. 296 (cost of such residence includes share of mortgage on building owned by the corporation). In the case of cooperative housing, the ownership requirement relates to the ownership of the stock and the use requirement relates to the house or apartment which the taxpayer is entitled to occupy as a stockholder. Qualified property also includes a condominium unit and the related undivided interest in the common areas. See Rev. Rul. 64-31, 1964-1 C. B. 300.

Under Section 1034, an exchange of stock in a cooperative housing corporation for a condominium unit and undivided interest in common areas resulted in nonrecognition treatment. See Rev. Rul. 85-132, 1985-2 C.B. 182. See also PLR 8322034 et. al. This may mean that the exclusion will be used up upon such a conversion and cannot be used again for 2 years (unless the partial exclusion rules apply). Further, if the gain exceeds the exclusion limits, gain may have to

be recognized upon such a conversion.

Qualified property includes a sailing yacht equipped with cooking, sleeping and sanitation facilities (PLR 8337050), a house trailer (Lokan, supra), a houseboat (Treas. Reg. 1.1034-1(c)(3)) and presumably a mobile home, including a vehicle or airplane as long as it is used as the taxpayer's principal residence. The sale of a furnished residence may cause gain to be recognized with respect to the furnishings if they are not "fixtures" under local law. Id.

Qualified property does not include mere contractual rights. Such contract rights include a right to purchase cooperative housing shares (see PLR 8704050), an accommodation in a nursing home (Rev. Rul. 60-135, 1960-1 C.B. 298), a transferrable membership in a retirement facility (PLR 8837022), a right to purchase a residence where material conditions have not been met (Occhipinti v. Commissioner, T.C. Memo 1969-190), a lease-option right where benefits and burdens of ownership have not passed to the lessee-optionee (Ryan v. Commissioner, T.C. Memo 1995-579), or an "equity share" interest pursuant to an unperformed oral agreement (Edmondson v. Commissioner, T.C. Memo 1996-393). However, the vendee's interest in a land sale contract should be qualified property as long as the benefits and burdens of ownership passed to the vendee. See Awalt v. Commissioner, T.C. Memo 1987-42.

What if the taxpayer is engaged in a business of selling his principal residence? Does the Section 121 exclusion still apply? In Grace v. Commissioner, T.C. Memo 1961-252, the court did not decide the issue of whether Section 1034 was applicable if the taxpayer was a dealer with respect to his old residence. The court simply found that the taxpayer did not hold his old residence primarily for sale to customers in the ordinary course of his trade or business. In Grace, the taxpayer was a builder of residences and apartment houses. He constructed a house on land that he had owned for about 18 years and moved in. Two years later he sold the property when an unsolicited offer was made. He sold the property in part because he needed a larger space to store his building materials and tools. The court noted that the record negated the Service's contention that the taxpayer had a consistent pattern of selling his personal residences. The taxpayer had owned only 4 residences in the last 14 years. Neither the statute nor the legislative history prohibit taxpayers from becoming "serial' home sellers. Congress could have enacted a minimum holding period that

was longer than 2 years but did not do so. But it is equally clear that the statute is not intended to apply to business property, but only to the taxpayer's principal residence.

As noted above, the term "residence" refers not only to the fact of abode, but also to the intention of remaining there. See Stolk, supra. Thus, the question may be one of the taxpayer's intent. If his primary motive is to live there as a residence without any present intention of leaving, the property should qualify under Section 121, regardless of how many similar sales the taxpayer has made in the past (although such sales may be evidence of the taxpayer's intent). If his primary motive is to hold the property for business or investment purposes, or if the taxpayer's residential use is incidental or intended to be temporary, the property may not quality under Section 121 as the taxpayer's "principal residence."

C. **Ownership Requirement**. The property must be owned and used by the taxpayer himself as his principal residence. Such ownership and use must be for periods aggregating 2 years or more in the 5-year period ending on the date of the sale or exchange of the property. Thus, if the taxpayer does not actually own the property, he will not qualify for the exclusion under Section 121. What does "ownership" mean in this context?

Under Section 1034, ownership has been strictly construed to mean the holding of legal title by the taxpayer himself, except in some special cases. Thus, property will not qualify as being owned by the taxpayer if it is actually owned by a partnership (see Walshe v. Commissioner, T.C. Memo 1994-46; Allied Marine Systems, Inc. v. Commissioner, T.C. Memo 1997-101); a nongrantor trust (Rev. Rul. 54-583, 1954-2 C.B. 158); the taxpayer's son or daughter (Rev. Rul. 55-37, 1955-1 C.B. 347; May v. Commissioner, T.C. Memo 1974-54; Calhoun v. Commissioner, T.C. Memo 1992-408, Moreno v. Commissioner 1997-218); the taxpayer's new spouse (Kirst v. Commissioner, T.C. Memo 1997-353; Feldman v. Commissioner, T.C. Memo 1996-132); the taxpayer's mother or parents (Marcello v. Commissioner, T.C. Memo 1964-299, aff'd on this point 380 F.2d 499 (5th Cir. 1967), cert. denied; DeOcampo v. Commissioner, T.C. Memo 1997-161); the taxpayer's friends (Edmondson v. Commissioner, T.C. Memo 1996-393); an estate (Mitchell v. United States, supra); (a trustee-in-bankruptcy (In re Mehr, 93-1 USTC Par. 50, 091 (B.C. N.J. 1993)); or the lessor and fee owner of the property (Boesel v. Commissioner, supra). Compare Rev. Rul. 82-1, 1982-1 C.B.

26 (estate); Rev. Rul. 85-45, 1985-1 C.B. 183 (trust).

Private agreements concerning the true ownership are likely to be insufficient. See Marcello, supra (taxpayer's mother was owner despite the fact that taxpayer made all mortgage payments and the existence of unrecorded affidavit signed by the mother designating the taxpayer as the true owner); Kirst, supra (oral agreement to transmute interest in new wife's property was ineffective, and court did not consider effect of written transmutation agreement executed after the replacement period); Feldman, supra (private agreement between husband and wife who held title as tenants by entirety was ineffective, although husband paid 100% of mortgage and renovation costs); DeOcampo, supra (taxpayer failed to establish that his parents acted as his agents where they acquired property in their own names and for their own account as represented in the purchase contract and obtained the mortgage using their personal credit, not that of a disclosed or undisclosed principal); Edmondson, supra (oral "equity share" agreement with taxpayer's friends was ineffective, where friends held title, were only borrowers on the deed of trust, and agreed to give future equity interest to taxpayer in exchange for renovations).

Under Section 1034, the reason for this rule was that holding title in another person could permit the sale of the new residence by the legal owner, while the taxpayer avoids paying tax on the deferred gain from the old residence. See Boesel and DeOcampo, supra. A similar reason could be found under Section 121 since the Government could otherwise be whipsawed. If legal title is held by another person who meets the requirements of Section 121 while the taxpayer does not, or if the taxpayer meets the requirements but the legal titleholder does not, the taxpayer and the legal titleholder could determine by their private agreement whether or not Section 121 applies to the transaction and to whom it applies. Accordingly, the ownership requirement of Section 121 is likely to be satisfied only by "LEGAL OWNERS OF RECORD." See Boesel, supra at 388.

There are several exceptions to this general rule. First, if title is held by a grantor trust, the trust is not regarded as a separate taxpayer and the grantor is considered to own the property. See Rev. Rul. 85-45, 1985-15 I.R.B. 6; Rev. Rul. 66-159, 1966-1, C.B. 162; PLRs 8717010, 8549046, 8313025, 8025027.

Second, the purchaser under a land sale contract is considered to own the property when

benefits and burdens of ownership pass to the purchaser, even though the seller retains legal title for security. See Awalt v. Commissioner. T.C. Memo 1987-42; PLR 8152103 (property was purchased when down payment was made at closing). Compare Ryan v. Commissioner, T.C. Memo 1995-579 (option agreement between taxpayers and tenants was not a completed sale since benefits and burdens of ownership did not pass to tenants, even though tenants paid a large amount for the option); Occhipinti v. Commissioner, T.C. Memo 1969-190 (contact to purchase was not a completed purchase where all material conditions of the contract were not met in the replacement period).

Third, Section 121 provides certain exceptions to the ownership requirement in the case of spouses, former spouses and surviving spouses. Under Section 121(b)(2), the $500,000 exclusion is available if the spouses file a joint return, either spouse meets the ownership requirement, both spouses meet the use requirement, and neither spouse used Section 121 in the 2-year period before the sale or exchange. Thus, ownership by either spouse counts for both spouses as long as they both meet the use requirement. If one spouse previously used the exclusion in the 2-year period, the other spouse may still file a joint return and receive a $250,000 exclusion for herself. See Section 121(d)(1).

Under Section 121(d)(3), if property is transferred from a spouse or former spouse, the transferee spouse includes the period that the transferor spouse owned the property, as long as the transfer is treated as a gift under Section 1041. A special exception is also made to the use requirement in the case of divorced taxpayers. The non-occupant spouse or former spouse is treated as using the property as his principal residence during any period of ownership while his spouse or former spouse is granted use of the property under a divorce or separation instrument (as defined in Section 71(b)(2)). Congress significantly liberalized the rules compared with prior law. See, e.g., Perry v. Commissioner, 91 F.3d 82 (9th Cir. 1996) aff'g T.C. Memo 1994-247 (taxpayer permanently vacated home 4 years before sale pursuant to divorce settlement, and home was not his principal residence); Young v. Commissioner T.C. Memo 1985-127 (nonrecognition of gain denied on sale of 25% interest in old residence occupied exclusively by ex-wife and daughter pursuant to divorce decree).

Under Section 121(d)(2), if a spouse dies before the home was sold, the surviving spouse is treated as owning and using the property for the period the deceased spouse owned and used the property. However, this rule only applies to a surviving spouse who does not remarry before the date of the sale or exchange of the residence. This is not much of a benefit in community property states where the basis in community property is stepped up for both spouses under Section 1014(b)(6). However, it will provide a benefit in common law states and for property acquired as a surviving joint tenant (where the surviving spouse would not otherwise receive a basis step-up as to her own interest).

The exception applies to both the ownership and use requirements. Thus, the surviving spouse may qualify for a $250,000 exclusion on sale as long as the deceased spouse met the ownership and use requirements, and even though the surviving spouse never actually owned or used the property as her principal residence. A $500,000 exclusion is presumably available if the house is sold during the year of the deceased spouse's death and a joint return is filed.

Section 121(d)(2) may encourage the deceased spouse's trust or estate to distribute the decedent's principal residence to the surviving spouse. The surviving spouse may claim the exclusion on sale even if she holds the residence for up to 3 years after the decedent's death (as long as the decedent met the requirements for the 2 years prior to his death). With respect to the surviving spouse, this provision should mitigate the effects of prior cases and rulings relating to property owned by nongrantor trusts and estates. Under Section 121(d)(2), the surviving spouse is <u>deemed</u> to own the property for the period the deceased spouse owned it.

A final exception to the ownership requirement is contained in Section 121(g). The aggregate period that prior residences were owned and used as the taxpayer's principal residence is taken into account if the gain on such residences was deferred under Section 1034 into the current residence. This aggregate period is included in determining the period for which a taxpayer has owned and used the current residence as his principal residence.

<u>Example</u>. The taxpayer (T) owned and used Blackacre as his principal residence for 2 years and sold it on January 1, 1997. On June 1, 1998 (within the 2-year replacement period of Section 1034), T acquires and moves into Whiteacre which has a cost equal to the adjusted sales price of

Blackacre. T defers recognition of $250,000 gain on the sale of Blackacre under Section 1034. T must use the rollover provisions of Section 1034 because Section 121 does not apply to sales or exchanges of a principal residence before May 7, 1997.

T can sell Whiteacre and use the exclusion under Section 121 even if T would not otherwise meet the 2-year ownership and use requirements. The ownership and use of Blackacre is included in determining the ownership and use of Whiteacre under Section 121(g). Query, however, whether T has made a valid replacement under Section 1034 if Whiteacre is sold the day after it is purchased. In that case, Whiteacre may not constitute T's new "residence" under Section 1034. Thus, gain may be recognized on T's 1997 return. (The attribution rule of Section 121(g) applies only for purposes of Section 121 and not Section 1034).

We note that holding legal title may be necessary but not sufficient, in and of itself, to constitute "ownership" under Section 121. The taxpayer must in fact have the benefits and burdens of ownership to be considered an owner for tax purposes. This issue arises in many areas of the tax law, but has also arisen under Section 1034. See, e.g., Scherr v. Commissioner, T.C. Memo 1993-87 (alleged acquisition of new home was sham where sellers were taxpayer's parents who continued to live in house and taxpayer did not make complete payments); Dunnegan v. Commissioner, T.C. Memo 1995-167, aff'd on this point 77 AFTR 2d 96-1504 (3d Cir. 1996) (taxpayer's cost of purchasing new residence did not include 100% of mortgage debt where he first bought the residence with his parents, as a tenant in common, over 4 years earlier; taxpayer didn't notify mortgagee of transfer of ownership, and mortgagee didn't release parents from debt obligation). See also Awalt, and Ryan supra.

D. **Use Requirements.** As noted in Stolk, the term "use" (as a verb) means "putting to service of a thing." Stolk, supra at 351. Generally, for property to be "used" by the taxpayer as his principal residence the taxpayer must physically occupy and live in the dwelling. See Perry v. Commissioner, supra; Young v. Commissioner, supra (citing Houlette v. Commissioner, 48 T.C. 350 (1967)). The legislative history to Section 121 also used the word "occupied" interchangeably with the term "used."

However, the courts and the Service have permitted certain exceptions to this general

presumption if the taxpayer leaves the residence temporarily and intends to return, or if the taxpayer must leave the residence for reasons beyond his control. See, e.g., Green v. Commissioner, 64 T.C.M. 369 (1992); Stolk, 40 T.C. at 343, 355. Pub. 523 and the Instructions to Form 2119 indicate that the taxpayer can count short temporary absences, such as for vacations or other seasonal absences, as time lived in the home, even if the taxpayer rented out the home during the absences. See also Treas. Reg. Section 1.121-1(d), Examples 4 and 5 (1-year sabbatical leave not temporary while 2-month vacation is disregarded). Section 121(d)(7) also provides an exception for out-of-residence care if the taxpayer is physically or mentally unable to care for himself (1-year ownership and use test).

Section 121 provides a bright-line test to avoid the kind of litigation that developed under Section 1034 when a taxpayer vacates a residence and "temporarily" rents it out before sale. See, e.g., Clapham. v. Commissioner, 63 T.C. 505 (1975) (residence sold was considered taxpayer's principal residence despite its intermittent rental for nearly 3 years while taxpayer looked for buyer); Barry v. Commissioner, 30 T.C.M. 758 (1971) (taxpayer rented home for 6 years and never occupied it before sale because of military service assignments); Trisko v. Commissioner, 29 T.C. 515 (1957) acq. 1959-1 C.B. 5 (taxpayer rented home for 3 1/2 years while on overseas government duty); Rev. Rul. 59-72, 1959-1 C.B. 203, revoking Rev. Rul. 55-222 (Service will follow Trisko only in factually similar cases).

Compare, e.g., Stolk, supra (sale 2 years after taxpayer vacated residence without any rental did not qualify under Section 1034); Houlette v. Commissioner, 48 T.C. 350 (1967) (taxpayer abandoned use as residence when house was sold 6 years after taxpayer left for job assignment and continuously rented property); Rogers v. Commissioner, T.C. Memo 1982-718 (military man abandoned house as residence where he leased house under series of 1-year leases and only attempted to sell during last 2 months of lease at constantly increased price); Stucchi v. Commissioner, T.C. Memo 1976-242 (taxpayer rented home to third tenant rather than occupy it after unsuccessful job relocation).

Section 121 should end much of this litigation. Cases like Clapham (sale within 3-year period after taxpayer vacated residence) and Stolk (sale 2 years after abandoning house as residence)

will qualify under Section 121. See also Andrews v. Commissioner, T.C. Memo 1981-247 (rental for a little over a year before sale); Bolaris v. Commissioner, 776 F2d 1428 (9th Cir. 1985), aff'g 81 T.C. 840 (1983) (rental for 8 or 9 months). Cases like Houlette and Barry (6 years of rental without occupancy) presumably will not qualify. The test is whether the taxpayer owned and used the property as his principal residence for periods aggregating 2 years in the 5-year period ending on the date of the sale or exchange of the property. Thus, as long as the taxpayer sells the property within 3 years after his occupancy ends, the taxpayer may exclude the gain under Section 121. The taxpayer may do so even if the property is vacant and abandoned, rented out, used for business purposes or converted to some other use.

But advisors should not purge the Clapham line of cases from your files. They will need to keep them in mind in any conversion of a principal residence to investment property. While the cases no longer have much importance under Section 121, they may have major significance under Section 1031 if a principal residence is rented out. The question is whether, under Section 1031, the property should be viewed as if it had remained the taxpayer's residence notwithstanding a short-term rental. If so, the property may not qualify as property held for business or investment purposes under Section 1031.

As noted above, Section 1221 provides certain exceptions to the "use" requirement for a surviving spouse or divorced spouse and where the residence was acquired in a Section 1034 rollover. However, there is no exception for a current or new spouse. To qualify for the $500,000 exclusion, both spouses must meet the 2-year use requirement. If one spouse does not, she may qualify for a partial exclusion under Section 121(c) depending on the facts. If one spouse doesn't qualify for any exclusion, the spouse who does qualify may take a $250,000 exclusion for his share of the gain, regardless of whether the couple files joint or separate returns. See Section 121(d)(1).

If one spouse does not meet the 2-year use requirement at the time of sale and that spouse has a 50% interest in the property, she may consider transferring the interest to her husband who meets the use requirement. The transfer is treated as a gift under Section 1041. Section 121(d)(3)(A) provides that the wife's period of ownership is attributed to the husband. Thus, the husband will be the 100% owner of the property upon sale and can exclude up to $250,000 in gain.

Otherwise, the wife will be taxed on her 50% share of the gain. Part of the husband's $250,000 exclusion may also go unused. Section 121 freely allows for transfers of interests between spouses. However, if the sale was already entered into by both spouses, a last-minute transfer of ownership may be disregarded for tax purposes. See Commissioner v. Court Holding Co., 324 U.S. 331 (1945).

E. Related Party Transactions. Section 121 opens the door to sales or exchanges of a principal residence with or by a related party. Only the sale or exchange of a remainder interest to a related party is not permitted under Section 121(d)(8). Section 1031(f) also permits exchanges between related parties as long as the replacement properties are held for 2 years after the exchange. A conversion of replacement property to a principal residence should not be a "disposition" under Section 1031(f). The 2-year periods under Section 121 and Section 1031(f) nicely coincide. Several private letter rulings have approved exchanges involving related parties and a principal residence and investment property. See PLRs 8946021, 8646036 and 8350084. See also Phillips and Rocca, Related Party Exchanges (11th Annual NRDC Conference) (April 16, 1998).

Section 121 will encourage gift giving to related persons. Taxpayers may more aggressively use their annual exclusion gifts under Section 2503 and their increasing unified credit under Section 2010. Assume that a taxpayer owned or acquires in an exchange an investment property with a $1,000,000 gain. The taxpayer and his wife gift the property to his son, daughter-in-law and their two children, using their annual exclusions ($20,000 per year per donee for gifts by the taxpayer and his wife) and part or all of their unified credits. If the property was recently acquired in an exchange, they should rent out the property and wait some time before making the gift. See Wagneson and Click discussed in Part III. The son and his family then live in the property for 2 years, after which they sell it and exclude up to $1 million in gain ($250,000 per owner).

This gift idea may be extended to the 4-unit condominium building in the example in Part I. If the taxpayer has more children or grandchildren (which could each live in a unit), the property could be disposed of free of income tax in 2 years. The transaction may make sense even if some gift tax must be paid, depending on the income tax savings, the post-gift appreciation, the taxpayer's age and other factors.

Section 121 will also allow related parties to sell their properties and obtain a basis step-up

in depreciable property. Sections 453(g), 707(b)(2) and 1239 will not apply to the extent that gain on the sale of the residence is excluded from income. The related buyer can use the property for business or investment purposes and receive greater depreciation deductions than the taxpayer would otherwise receive.

F. **Special Rules**. This section covers additional rules that may be relevant to the interplay between Sections 121 and 1031, including the partial exclusion of gain, sale or exchange requirement, depreciation recapture rule for depreciation allowable after May 6, 1997, and electing out of Section 121. There is also a special rule for involuntary conversions. Under Section 121(d)(5), gain on a residence that is involuntarily converted may first be excluded under Section 121 up to the $250,000 or $500,000 limits, and the balance of the gain may be deferred under Section 1033 by acquiring a replacement residence. The rule parallels the combined use of old Section 121 and Sections 1033 or 1034 under prior law.

1. **Partial Exclusion**. Section 121(c) allows for a partial exclusion of gain if a sale or exchange of the residence is by reason of a change in place of employment, health or, to the extent provided in regulations, unforeseen circumstances. Since no regulations have been issued concerning "unforeseen circumstances," the only reliable exceptions are for employment relocations and health. See, e.g., Cronhardt v. Commissioner, T.C. Memo 1986-399 (gain on second sale in 2 years was not recognized under Section 1034 where second residence was sold in connection with taxpayer's move to different area to become self-employed in full-time horse business).

If the sale is attributable to employment relocation or health, then the taxpayer may qualify for a partial exclusion of gain under Section 121(c), even though the 2-year ownership and use test is not met, and even though more than one excluded sale of a principal residence will occur within 2 years of each other. The partial exclusion is equal to the $250,000 or $500,000 exclusion multiplied by a fraction. The fraction is the smaller of (a) the actual ownership and use period divided by 2 years or (b) the period after the most recent prior sale that was excluded under Section 121(a) divided by 2 years.

Example. The taxpayer (T) owns and uses Whiteacre as his principal residence for 18 months. T then sells the property due to a job relocation. Assuming that Section 121(b)(3) does not

apply (only one excluded sale every 2 years), T can exclude gain of up to $187,500 under Section 121(c), computed as follows: $250,000 x 18 months/24 months.

Now assume that T sold Blackacre 1 year before the sale of Whiteacre and Section 121(a) applied to the sale of Blackacre. T can exclude gain using the smaller of the two fractions. T can exclude gain of up to $125,000 under Section 121(c), computed as follows: $250,000 x 1 year/2 years.

2. **Sale or Exchange.** Section 121 only applies to a sale or exchange of the property and not to a contribution, gift, lease, mortgage or other transaction. Property may be deemed to be sold if the taxpayer's liability relief exceeds his adjusted basis. Section 121 may also apply if a lender forecloses on the property and the taxpayer realizes a tax gain. Section 121(d)(5) provides that the destruction, theft, seizure, requisition or condemnation of property is treated as a sale of the property. Both Sections 121 and 1033 may apply to such a "sale." Most importantly, Section 121 applies to exchanges of the property, including like-kind exchanges under Section 1031.

3. **Depreciation Recapture.** Section 121(d)(6) contains a depreciation recapture rule for gain attributable to any depreciation allowable after May 6, 1997 with respect to the property. Thus, if the taxpayer depreciates a home office or rented room, or if he converts a rental or business property to his principal residence, the gain attributable to the depreciation allowable after May 6, 1997 must be recognized. Under Section 1(h), the depreciation will be taxed at a top rate of 25% for assets held more than 18 months (assuming that the depreciation is not ordinary income under Section 1250). This recapture rule applies even if there is no recapture under Section 1250 (i.e., no deprecation was taken in excess of straight-line depreciation).

The good news is that all depreciation allowable before May 7, 1997 is not recaptured under this provision. In contrast, Section 1(h) is not so limited. It applies the 25% rate to recognized gain attributable to any depreciation allowable, including depreciation before May 7, 1997. But if no gain is recognized on the sale or exchange under Section 121 or Section 1031 (and assuming there is no depreciation recapture under Section 121(d)(6) or Section 1250), the gain attributable to prior depreciation is simply not taxed.

The depreciation recapture rule reduces the tax benefit of converting a rental property into a principal residence and selling it 2 years later. The depreciation allowable after May 6, 1997 is taxed, although the balance of the gain is excluded up to the $250,000 and $500,000 limits. Similarly, the rule reduces the tax benefit of depreciating a home office, rented rooms or other business use of a residence. Nonetheless, there is a timing and tax rate advantage to the depreciation if it can be currently deducted and offset income taxed at higher rates. Further, all of the depreciation taken before May 7, 1997 will <u>not</u> be recaptured upon the subsequent sale of the residence.

4. **<u>Election Out</u>**. Section 121(f) provides the taxpayer may elect not to have Section 121 apply to any sale or exchange. The election may be desirable if the taxpayer will sell or exchange more than one principal residence in any 2-year period. The taxpayer will elect to use the exclusion for the sale generating the most gain.

<u>Example</u>. T used Blackacre as his principal residence for all of 1995 and 1996 and has a $200,000 gain in that property. T used Whiteacre as his principal residence for all of 1997 and 1998 and has a $40,000 gain in that property. In 1999 T sells Blackacre and Whiteacre and moves to Greenacre. T can use the exclusion for only one sale or exchange every 2 years under Section 121(b)(3). T will apply the exclusion to Blackacre which has a larger gain and elect not to use it on Whiteacre. T could have used the exclusion for both properties if, for example, he sold Blackacre on January 1, 1998 and sold Whiteacre on January 2, 2000. T may also qualify for a partial exclusion as to Whiteacre if the sale is by reason of a job relocation or health.

There are not may other reasons to elect out of Section 121. The gain is excluded from income and does not result in a lower basis on a new residence or other property received after the sale or in an exchange. Section 121 can be combined with Section 1033 in the case of an involuntary conversion under Section 121(d)(5) and an installment sale under Section 453. See Rev. Rul. 75, 1953-1 C.B. 83. Even if the taxpayer has loss carryovers, why use them up on gain that may be excluded from income?

5. **<u>Rental or Business Use</u>**. The Service has indicated that Section 121 may apply to the business or rental use of the property if the taxpayer otherwise qualifies for the

exclusion and if the business or rental use does not exceed 3 years of the 5-year period ending on the sale date. The Instructions to Form 2119 state: "To do so, allocate any allowable exclusion between Forms 2119 and 4797. Attach a statement showing the total exclusion and the method used to allocate it between the two forms. Enter on Form 2119… only the part of the exclusion that applies to the main home. On the dotted line next to line 14 or line 27 [of Form 2119], write 'Allocated.' For details on how to report the part of the exclusion that applies to the rental or business use, see Special Rules in the Form 4797 Instructions."

The Instructions to Form 4797 state: "If you rented or used part of your home for business and meet certain requirements, you may be able to exclude part or all of the gain figured on Form 4797 . . . . If the home was held more than 1 year, on line 2 of Form 4797, write 'Section 121 exclusion' and enter the business part of the exclusion as a (loss) . . . . Complete Part II or Part IV of Form 2119 and attach it and Form 4797 to your return. If the home was held for 1 year or less, report the sale and business part of the exclusion in a similar manner on line 10 of Form 4797."

These instructions and Pub. 523 refer to cases where the home was rented or part of the home was used for business, indicating that these rules at least apply to mixed-use property. But presumably the same rules apply where the property had different uses at different times (i.e., first as a principal residence and later as a rental or business property). In that case, the gain or loss would be figured on Form 4797. The Section 121 exclusion would be determined on Form 2119, carried to Form 4797 and reported as a "loss" to offset the gain up to the $250,000 and $500,000 limits.

Clearly, the Service has not perfected these instructions. The Service is not yet accustomed to applying an exclusion for a residence sale to sales of "business property" on Form 4797. But since the property need not be the taxpayer's principal residence at the time of sale, the property may be converted to business or rental property for up to 3 years of the 5-year period. The Section 121 exclusion will apply as long as the 2 out of 5 year test is met. Since the property may be business property at the time of sale, the sale must be reported on Form 4797 and the exclusion must be taken into account on that form.

The instructions are not only evasive about a property with different uses at different times,

but they are totally silent on the question of a like-kind exchange. Congress also did not directly address this issue. It merely provided a rule to coordinate the exclusion with an involuntary conversion under Section 121(d)(5). What does this mean? Does the exclusion apply if the taxpayer meets the 2 out of 5 year test but the residence is converted to business or rental property and exchanged under Section 1031? Is such property allowed to be exchanged under Section 1031 in light of Section 121?

F. **Relationship with Section 1031.** Assume that a property has been owned and occupied by the taxpayer as his principal residence for 2 years. Then the taxpayer moves out, never intending to return, and rents the property at fair market value for 2 years. If the property is then exchanged for investment property, does Section 121 apply? Does Section 1031 apply? Does either of them apply at the election of the taxpayer? Do both provisions apply in combination?

Section 121 has three possible relationships between Section 1031. First, Section 121 could preempt the field, such that Section 1031 could never apply to the property while Section 121 applies to it. Second, Section 121 and Section 1031 could both apply to the property but taxpayers must choose which treatment applies. Finally, both provisions could apply and be used in combination to exclude and defer recognition of the gain.

The preemption theory is rooted in Starker v. United States, 602 F.2d 1341 (9th Cir. 1979). The court stated: "It has long been the rule that the use of property solely as a personal residence is antithetical to its being held for investment. Losses on the sale or exchange of such property cannot be deducted for his reason, despite the general rule that lasses from transactions involving trade or investment properties are deductible. (Citations omitted.) A similar rule must obtain in construing the term "held for investment" in Section 1031. (Citations omitted.) Thus, nonrecognition treatment cannot be given to the receipt of the Timian parcel." Id. at 1350-1351. [The Timian parcel was a personal residence conveyed directly to the taxpayer's daughter.]

But Starker does not apply to the case presented above. Here the property is not used "solely as a personal residence." Rather the property has different uses at different times, first as a principal residence for 2 years and then as a rental property for 2 years. The cases and rulings under Section 1031 indicate that property held for at least 2 years as rental property may be "held for investment"

within the meaning of Section 1031. The fact that Congress also allows the property to qualify for the Section 121 exclusion is immaterial to the question presented under Section 1031 (i.e., whether the property is held for business or investment purposes at the time of the exchange). Neither Section 121 nor Section 1031 indicate that such property cannot be considered as held for investment under Section 1031.

Pub. 523 and the Instructions to Forms 2119 and 4797 indicate that the Service has not adopted the preemption theory. Instead, the business or rental portion of the property is reported on Form 4797. The exclusion under Section 121 is then allocated between Forms 2119 and 4797. The instructions to Form 2119 also state that, while the exclusion may apply to the business property, "you cannot postpone the part of the gain that is reported on Form 4797." But this refers to recognized gain that must otherwise be reported on Form 4797. The Instructions do not state whether or not such gain may be deferred in a Section 1031 exchange that is reported on Form 8824.

Assuming that the property qualifies under both Section 121 and Section 1031, must the taxpayer pick and choose which treatment applies? For example, the taxpayer could treat the property as his principal residence and exclude the gain under Section 121. Alternatively, he could treat the property as investment property and exchange it for like-kind property under Section 1031. Suppose the taxpayer effects a Section 1031 exchange. If the tax advisor was concerned with the possible application of the preemption theory to the exchange or wanted to ensure that Section 121 was available for another sale in the 2-year period, an election may be made out of Section 121. But it is unclear how the election is to be made (e.g., in the same manner as the election under Treas. Reg. Section 1.121-4). It is also unclear whether the election would be effective for any reason other than rendering the exclusion inapplicable. The question of whether the property was held for investment will remain, regardless of any election out of Section 121.

Finally, Section 121 and Section 1031 may be complementary, and both provisions may apply to a Section 1031 exchange of the property. The governing statutes seem to permit this result, but do not expressly say so. Compare Section 121(d)(5) (in the case of an involuntary conversion, both Section 121 and Section 1033 may apply to the sale). In the case of mixed-use property, prior cases and rulings have held that Section 1034 applied to the residence portion of the property and

Section 1031 applied to the business or investment portion. The reason is that two separate nonrecognition provisions may apply to the transaction, depending on the uses of the property. As long as the requirements of each section are met, each section is applied to the different portions of the property as if they were disposed of in separate transactions. See, e.g., Rev. Rul. 59-229, Sayre and Coupe, supra.

Our example is different in that the property does not have multiple uses at the time of the exchange, but instead had different uses at different times of ownership. However, there is a strong argument that both provisions should apply to the exchange as long as the specific requirements of each section are met. If Congress wanted to prevent the combined use of Section 121 and Section 1031 in the case of an exchange, Congress could have done so but did not. Rather, Congress expressly provided that Section 121 shall apply to both a sale and an exchange of the property. Congress was presumably aware that Section 1031 may apply to an exchange of converted property.

Example. The taxpayer (husband and wife) own a luxury condominium unit with a $3 million gain. They have lived at the unit for the last 2 years and desire to move out and convert the property to a rental property. They rent the property to a third party at a fair market rent for 2 1/2 years, reporting their income and expenses on Schedule E, Part I. The property has been continuously rented without any listing for sale or other attempts to sell the property. After 2 1/2 years of renting the property, the real estate market has improved, and the taxpayers want to exchange the condominium unit for like-kind property to be held for investment under Section 1031.

They exchange the property 4 months later for another luxury condominium unit which is rented out. At the time of the exchange, the old unit has a value of $5 million and gain of $3.5 million. The new unit has a value of $4.5 million. Assume that the exchange meets all of the other requirements of Section 1031. The taxpayers receive $500,000 in boot on the exchange because they have other bills to pay. The remaining equity is invested in the replacement property. What are the tax consequences of this transaction? How is the transaction reported?

First, the taxpayers qualify for the $500,000 exclusion of gain under Section 121. They owned and used the property as their principal residence for 2 years during the 5-year period ending on the date of the exchange. Second, the requirements of Section 1031 are met with respect to the

exchange, except that gain must be recognized to the extent of the boot received under Section 1031(b). On these facts, the taxpayers should be deemed to have held the old property for investment under Section 1031. The new property will also be rented out and held for investment.

The like-kind exchange is reported on Form 8824. The taxpayers received $500,000 so the gain recognized on the exchange is $500,000. The basis in the new unit is $1.5 million which is equal to the basis of the old unit. The basis is also equal to the value of the new unit ($4.5 million) less the deferred gain ($3 million). Thus, the remaining gain of $3 million is preserved in the basis of the new unit.

The $500,000 of gain recognized on the exchange is carried to Form 4797. On Form 4797, the gain is reported on line 5, column (h). Form 2119 is also completed with respect to the exclusion. The $500,000 exclusion is shown as "allocated" 100% to Form 4797. The Section 121 exclusion is then applied as a "loss" on line 2, column (g), in accordance with the Instructions to Forms 2119 and 4797.

If Sections 121 and 1031 are in fact complementary and both provisions apply to the exchange, the taxpayers achieve the following tax results:

1. They receive $500,000 in cash without paying any tax due to the exclusion. (The $500,000 in cash received would otherwise have been taxable to them if the exclusion did not apply.)

2. They defer recognition of the remaining $3 in gain through a Section 1031 exchange. (If they had continued to use the property as their residence and sold it, they would have paid tax on this $3 million gain since the exclusion is limited to $500,000.)

3. They may repeat this process for the new unit after renting it out for a sufficient period of time. (The exclusion may be used once every 2 years. To be reasonably safe, the taxpayers should rent out the new unit at fair market value for at least 2 years. Future use of the new unit as their residence should not be intended or a fait accompli at the time of the exchange.)

Sections 121 and 1031 are not complementary provisions, however, when the conversion goes the other way and the property is converted from an investment property to a principal residence. Only Section 121 may apply to property converted to a principal residence. Taxpayers are limited to excluding gain of up to $250,000 or $500,000 after the conversion to a principal residence. Section 1031 will not apply to defer tax on any remaining gain even if the residence is exchanged for investment property. See, e.g., Starker, supra; Click v. Commissioner, 78 T.C. 225 (1982) (property used as residence by children and gifted 7 months after exchange did not qualify).

In PLR 8915012 (January 5, 1988), the taxpayer planned to use the replacement property as his personal residence after the exchange. The Service held that exchange did not qualify under Section 1031. Section 1031 excludes personal residences by implication since it only applies to property held for productive use in a trade or business or for investment at the time of the exchange. See Click, supra; Bolker v. Commissioner, 760 F.2d 1039 (9th Cir. 1985) (intent to sell property or use it for personal pursuits is not holding for investment). Compare Heiner v. Tindle, 276 U.S. 582 (1928) (the Court did not decide whether a personal residence could be considered held for profit, but subsequent cases have held or assumed that a personal residence is not held for the production of income).

Thus, Sections 121 and 1031 are closely connected when property is converted from a principal residence to investment property before an exchange. An issue arises, however, as to whether the relinquished property was held for investment under Section 1031. Similarly, if replacement property is converted to a residence after an exchange, an issue arises concerning whether the replacement property was to be held for investment. Finally, there are cases of mixed-use property where Sections 121 and 1031 may apply separately or in combination to different parts of the property.

III. Conversions of Property

A taxpayer may want to convert his principal residence into investment property if his gain significantly exceeds the $250,000 or $500,000 exclusion limits. All of the gain may then be deferred in a subsequent Section 1031 exchange. Some of the gain may also be excluded if Section 121 applies to the exchange. Conversely, a taxpayer may want to convert investment property

received in an exchange to his principal residence, live there for 2 years, and exclude the gain on sale under Section 121.

In some cases the taxpayer may be able to convert a portion of his residence into business or investment property and sell the residential portion. On the portion sold, the gain may be excluded under Section 121. A basis offset will apply in determining the gain on the residence portion which may allow the taxpayer to receive more tax-free cash. The portion held for business or investment purposes may be exchanged for like-kind property under Section 1031. The value of the replacement property needed to defer the gain will be lower than what it otherwise would be if the entire property was converted.

These techniques depend on the validity and effect of a "conversion" of the property under Section 1031. The conversion must allow for the property to qualify or remain qualified under Section 1031. These techniques also depend on the fact that a conversion of property is not treated as a "disposition" upon which gain is realized. But should Section 1031, in principle, apply to gain accrued while property was held for a long period of time as a personal residence? Compare Heiner v. Tindle, supra; Treas. Reg. Sections 1.165-9(b)(2) and 1.167(g)-1 (providing a special "loss basis" rule when a personal residence is converted to business or investment property). Like the all-or-nothing treatment applied to capital gain or ordinary income, the gain is not bifurcated under Section 1031.

A. **Conversion Before Exchange.** Unfortunately, there is little authority concerning the factors that determine whether a residence has been converted into investment property prior to a Section 1031 exchange. In Rev. Rul. 57-244, 1957-1 C.B. 247, the taxpayers acquired 25 acres of undeveloped land in a residential suburb of a city. The land was purchased by each of them for the purposes of constructing homes thereon. Shortly after the acquisition of the land, the taxpayers abandoned their plans to construct homes. They did not then dispose of the property but continued to hold it for investment purposes. Five years afer the acquisition, the taxpayers agreed to exchange lots between themselves, and the Service held that the exchange qualified under Section 1031.

The ruling indicates that the taxpayers abandoned their original residential purpose and then held the property for 5 years before the exchange. This may be a very conservative "safe harbor"

for the conversion of a residence to investment property. But it is not helpful to taxpayers who want to use both provisions after a conversion in the 5-year period under Section 121. The ruling also does not address rental or business property.

Here the standard set forth in the Starker case may apply. The court indicated that property is held for investment purposes within the meaning of Section 1031 if losses from the sale or exchange of such property are deductible. Starker, supra at 1350-1351 (citing Treas. Reg. Section 1.165-9(a) and Shields v. Commissioner, T.C. Memo 1978-120). See also Serdar v. Commissioner, T.C. Memo 1986-504, n.13.

Treas. Reg. Section 1.165-9(b) provides that if a residence is "rented or otherwise appropriated to income-producing purposes and is used for such purposes up to the time of its sale," a loss is allowed as a deduction under Section 165(a). The basis for determining the loss is limited, however, to the lesser of the fair market value of the property at the time of conversion or the adjusted basis at that time. Two examples illustrate these rules. In both examples, the taxpayer used the property as his personal residence and then rented the property for 3 years or 4 years before sale. See Treas. Reg. Section 1.165-9(c).

Starker stated that this standard applies under Section 1031 in the case of a personal residence. If Starker is correct, then the test is pretty clear: the residence must be "rented or otherwise appropriated to income-producing purposes" up to the time of the exchange. In a line of cases under Section 165(c), the courts have held that a former residence must be actually rented in order to deduct a loss upon a subsequent sale. In contrast, expenses and depreciation may be deducted under Sections 167 and 212 when property is listed for rental. In Cowles v. Commissioner, 29 T.C.M. 884 (1970), the court stated:

"It is not readily apparent how a mere offer to rent property is sufficient to justify a holding that it is 'held for the production of income' within the meaning of sections 212 and 167 but not sufficient to permit a holding that it is 'otherwise appropriated to income-producing purposes' within the meaning of section 1.165-9, Income Tax Regs. But such a distinction has long been established in the decided cases. Perhaps if we were writing on a clean slate, we would be inclined to reexamine this distinction. But, in light of the foregoing decisions, as well as those hereinafter

cited, we are unwilling to chart a new course . . . ." [Citations omitted.]

The statement in Starker may be regarded as dictum. The court failed to include as "investment property" a residence held for the production of income under Sections 167 and 212, implying that a former residence must be actually rented in order to qualify under Section 1031. But this question was not before the court since the residence at issue was used solely as a personal residence. The regulations under Section 1031 may also be contrary to Starker on this point. Property held for investment includes property which is held for the future realization of an increase in value although it is otherwise unproductive. See Treas. Reg. Section 1.1031(a)-1(b). Nonetheless, the statement in Starker was quoted with approval in Serdar as if it were settled law. Renting a former residence for a significant period of time is advisable (if not required) before undertaking a Section 1031 exchange.

Under the Starker standard, other authorities may be relevant in determining the taxpayer's primary motive. Section 165(c)(1) and (2) limits the deductibility of losses for individuals to those incurred in a trade or business or a transaction entered into for profit. To be deductible under Section 165(c)(2), the taxpayer's primary motive must be to make a profit. See Heltzer v. Commissioner, T.C. Memo 1991-404; Ewing v. Commissioner, 91 T.C. 396, 417-418 (1988); Fox v. Commissioner, 82 T.C. 1001, 1021 (1984).

The Ewing guidelines are as follows:

(1) The ultimate issue is profit motive, not profit potential, although profit potential is considered in determining motive.

(2) Profit motive refers to economic profit independent of tax savings.

(3) Profit motive is determined with respect to the overall transaction.

(4) Profit motive must be primary, or of first importance. Greater weight is given to objective facts as opposed to self-serving statements.

(5) The main focus is on the motive at the time the transactions were entered into. However, all circumstances surrounding the transactions are considered in

determining profit motive.

See Ewing v. Commissioner, supra at 418, citing Fox v. Commissioner, supra at 1018-1022.

In Serdar, the court stated: "The fact that petitioners intended to allow their son and his family to reside at Engelhart Farm does not, as respondent suggests, settle the issue of whether petitioners intended to hold Engelhart Farm for investment purposes. A taxpayer's intent to hold property for investment must be determined as of the time of the exchange. Click v. Commissioner, 78 T.C. 225, 231 (1982). For purposes of sec. 1031, property is held for investment purposes if losses from the sale or exchange of such property are deductible. Starker v. United States, 602 F.2d 1341, 1350-1351 (9th Cir. 1979). When property is purchased both to provide a residence for relatives, and for investments purposes, a loss from the sale or exchange of the property is deductible if it is held primarily for investment purposes. Jefferson v. Commissioner, 50 T.C. 963, 968 (1968). Whether property is held primarily for investment purposes is a question of fact. Jefferson v. Commissioner, supra." Serdar, at n.13 (dicta which was not part of the court's holding since the Service's challenge to the exchange was untimely).

As noted in Serdar, the question of a primary investment motive is one of fact. All of the facts and circumstances relating to the property will be considered including the nature and extent of the rental or business use, whether the taxpayer has abandoned all personal use with no intention of returning, and the length of time that the property was rented or used for business purposes. Thus, there is no bright-line test for whether or not a conversion occurs. If a rental or business use is not profitable, such use may not be for business or investment purposes, and the "conversion" to qualified property under Section 1031 may not occur. See Dawson v. Commissioner, 31 T.C.M. 5 (1972). Similarly, if the property is listed for sale after the taxpayer moves out and only temporarily rented out incident to a sale, the property may be held "primarily for sale." Such property is excluded from nonrecognition treatment under Section 1031. See Section 1031(a)(2)(A). The Clapham line of cases (originally pro-taxpayer holdings under Section 1034) may now be turned against taxpayers if they attempt to exchange a former residence under Section 1031.

Other commentators have analyzed this issue and concluded as follows: "The most critical factors in determining whether such a conversion has occurred focus on the reality of the leasing

transaction, the length of the term and whether a fair market rental is charged. (Citations omitted.) The success of this tactic depends on the length of the rental term, the length of time the house was used as a residence before rental, whether all personal use of the house was permanently abandoned, the character of the house (recreational or otherwise), the existence of offer to sell or rent, the amount of rent, and the absence of a prearranged exchange." See Fainsbert, Mase and Synder, Real Property Exchanges (CEB 2d Ed. 1995) at 114.

Contrary to Starker, "property held for investment" under Section 1031 may include "property held for the production of income" under Sections 167 and 212. If this is correct, then a former residence need not be actually rented before the exchange. Under Treas. Reg. Section 1.1031(a)-1(b), property held for investment includes property held for the future realization of an increase in value although it is otherwise unproductive. Similarly, property held for the production of income includes property which may generate income in future years, including gain from the disposition of the property. See Treas. Reg. Section 1.212-1(b).

In Newcombe v. Commissioner, 54 T.C. 1298 (1970), the taxpayer retired and moved to Florida, listing his residence for sale but not for rent. He did not sell the property until 14 months later. While the property was on the market, he claimed depreciation and maintenance expenses on the ground that the property was held for the production of income. The Court stated that a variety of factors must be considered, including offers to rent and offers to sell, and rejected the Service's contention that the residence would be considered converted only if it were rented or offered for rent. But the court held against the taxpayer. In particular, the taxpayer's marketing of the property shortly after abandoning it as a residence showed that the property was not held for income-producing purposes.

The court in Newcombe went on to say that an expectation of post-conversion profit indicates that the property is held for the production of income. Under the standard set forth in Treas. Reg. Section 1.1031(a)-1(b), this would also indicate that the property is held for investment. The court stated: "If a taxpayer believes that the value of the property may appreciate and decides to hold it for some period in order to realize upon such anticipated appreciation, as well as an excess over his investment, it can be said that the property is being 'held for the production of income.'

And this would be true regardless of whether his expectation of gain was reasonable." Newcombe, supra at 1302-1303. (Emphasis in original.)

In Bolaris v. Commissioner, 776 F.2d 1428 (9th Cir. 1985), the taxpayers had rented out their old residence at fair market value on a month-to-month basis for 8 to 9 months while attempting to sell it. The court held that they were entitled to: (1) take depreciation and expense deductions attributable to the period of the rental under Sections 167 and 212 and (2) defer tax on the gain under Section 1034 once the house sold. To qualify as property held for the production of income under Sections 167 sand 212, the taxpayers had to be engaged in the rental activity with the primary purpose of making a profit. The court held that this profit motive was shown by factors such as the fair market rental.

In summary, taxpayers should be prepared to establish that the relinquished property was "converted" and held for investment at the time of the exchange. The following facts would be helpful in doing so:

(1) Actual rental or leasing of the relinquished property at fair market value for as long as possible (2 to 3 years should be safe, although a profitable rental for a shorter period of time may also effect a conversion);

(2) The absence of any listing for sale or other marketing of the property immediately after the taxpayer vacates the residence (the rejection of unsolicited offers would help rather than hurt);

(3) The abandonment of all personal use of the residence, and the intention of never returning there to live; and

(4) An expectation of post-conversion profit (which may or may not be supported by economic forecasts and market trends).

B. **Conversion After Exchange**. If the replacement property is immediately converted to the taxpayer's residence, the exchange is likely to be challenged by the Service and disallowed. In PLR 8915012, the taxpayer "planned" to use the replacement property as his personal residence after the exchange. The exchange did not qualify under Section 1031 because the replacement property

was not to be held for business or investment purposes. See also Starker and Click, supra. An immediate conversion of the replacement property to a personal residence is strong evidence that the taxpayer did not intend to hold it for a qualified purpose at the time of the exchange. In this respect the conversion is similar to a disposition of the property shortly after the exchange that causes the exchange to be taxed. See cases cited under "Holding Period" below.

In Wagnesen v. Commissioner, 74 T.C. 653 (1980), the taxpayer exchanged his ranch for another ranch. Nine months later, he made a gift of the new ranch and some cash to his son and daughter. The court found that the taxpayer had no "concrete plans" at the time of the exchange to make the later gift. First, the taxpayer did not initiate discussions with his accountants about a gift until after the exchange. Second, the taxpayer used the ranch in his ranching business during the period between the exchange and the gift. After the taxpayer gave the ranch to his children, the ranch continued to be used for business purposes by the partnership of the taxpayer and his son through the date of trial.

The court held in favor of the taxpayer. The court noted that a "general desire" to make a gift is not inconsistent with an intent to hold the acquired ranch for productive use or for investment. The court also stated that the gift was not part of the exchange transaction, in light of the facts of the case. Two years later the Tax Court reach a seemingly contrary result in Click, supra.

In Click, the taxpayer acquired two residences in exchange for farmland. The residences were gifted to her children 7 months after the exchange. The court stated that the taxpayer's intent to hold the property for investment must be determined as of the time of the exchange. Further, the taxpayer has the burden of proving that she had the requisite investment intent. The Service argued that the taxpayer's intent was not to hold the houses for investment but rather to gift them to her children. The taxpayer countered that she had no "concrete plan" to transfer the houses to her children at the time of the exchange, citing Wagnesen. The taxpayer further stated that she took the property because she wanted "something that would grow in value." She argued that she held the houses as an investment for 7 months after the exchange, at which time she decided to gift them to her children. The court held against the taxpayer and distinguished Wagnesen based on the facts.

In Click, the taxpayer's children looked for the replacement property and found residences that suited their lifestyles and desires for larger homes and more land. The taxpayer, who was an experienced investor, did not personally select and never saw the replacement properties until after the buyer made its purchase offer. The taxpayer's estate planning activities also indicated an intent at the time of the exchange to gift the residences to her children. While the taxpayer normally took care of her investments and obtained insurance, she did not do so with respect the residences acquired in the exchange. The children paid the taxes and insurance, treated the properties as their own, lived there rent free during the 7-month period before the gift, and spent money on improvements that were more in the nature of personal custom features than for general maintenance. The fact that the children did not obtain the taxpayer's approval for the improvements further belied the taxpayer's contention that her children lived in the houses as "caretakers" during the period between the exchange and the gift.

On these facts, the court held that the taxpayer did not have the requisite investment intent in accepting the homes as replacement properties. Rather, her primary purpose was to provide larger homes in which her children and grandchildren could reside. The taxpayer also acquired the residences with the intent of making gifts of them to her children and not to hold as investments for eventual sale.

The Service has ruled that personal use of the property 10 days per year for maintenance purposes will not disqualify an exchange. See PLR 8103117. The ruling also indicates that the acquisition of property for enjoyment of a sound and growing community is consistent with an investment purpose.

A similar test to conversions before an exchange should apply to conversions after an exchange. The test appears to be whether the taxpayer had a primary investment motive at the time of the exchange, which is a question of fact. See Serdar, supra. In Bolker, the court noted that holding property for investment is inconsistent with an intention to liquidate the property or use it for personal pursuits. The court noted that its test was equally applicable to the relinquished and replacement properties.

In summary, taxpayers should be prepared to prove that the replacement property was not

intended to be used as the taxpayer's residence at the time of the exchange. The following facts would be helpful in doing so:

1. Actual rental or leasing of the replacement property for fair market value for as long as possible after the exchange (a rental of 2 or 3 years should be safe, although a shorter period of rental may be permissible depending on the facts);

2. The absence of an owner-occupier loan (which may be fraudulent to the lender if the property is actually rented and is likely to disqualify the exchange in any event);

3. The absence of any claim for a homeowner's exemption and the taxpayer's payment of any rental license fees or taxes;

4. Limiting improvements to the property to general maintenance and not personal custom features;

5. No personal use of the property (short periods of use for maintenance and re-renting purposes are permissible);

6. No "concrete plan" to convert the property to a personal residence at the time of the exchange (e.g., after a period of rental, the tenant moves out, a desirable new tenant cannot be found, and the taxpayer subsequently decides to sell his home and move there to reduce overall carrying costs).

C. **Holding Period**. Over and over again, clients ask what is a safe holding period for the relinquished or replacement property. Answers are given such as until the next tax year, one year or two years. But no one knows for sure. In fact, Section 1031 provides for no fixed "holding period." The question is simply the taxpayer's intent at the time of the exchange. Since this intent is objectively determined, however, how long the taxpayer holds the property for a qualified use is very relevant.

Since there is no fixed holding period under Section 1031, any conversion of the property close in time to the exchange may be questioned. In 1989, the House proposed a 1-year holding period for Section 1031 exchanges. See H.R. Rep. No. 101-247, 101st Cong., 1st Sess. (1989).

Unlike the related party rules of Section 1031(f) which were enacted, the House's proposed 1-year holding period was rejected by the Senate. Apparently, it was viewed as being too strict, especially with respect to dispositions in nonrecognition transactions.

In one ruling, the Service stated that a holding period of at least 2 years for use as a rental property was sufficient to show the taxpayer's investment purpose. See PLR 8429039 (April 17, 1984) (the exchange was first disapproved in PLR 8310016 when the taxpayer represented that the replacement property would be sold soon after its acquisition). See also PLR 7825002 (condominiums rented back to seller for at least 2 years were held for investment). The 2-year holding period could be viewed as a safe harbor in light of these rulings.

The cases and rulings relating to the "holding" issue reach varying and inconsistent results. With respect to the relinquished property, see Bolker v. Commissioner, supra (taxpayer exchanged property 3 months after receipt in corporate liquidation); 124 Front St., Inc. v. Commissioner, 65 TC 6 (1965), acq. 1976-2 C.B. 3 (taxpayer exchanged property after 6 months); Rutherford v. Commissioner, TC Memo 1978-505 (relinquished property transferred upon birth); Allegheny County Auto Mart, Inc. v. Commissioner, 12 TCM 427, aff'd 208 F.2d 693 (3d Cir. 1953) (relinquished property owned for 5 days before exchange). Compare Rev. Rul. 77-297, 1977-2 C.B. 304 (property acquired immediately before exchange, for the sole purpose of transferring it in the exchange, was not held for a qualified use); Rev. Rul. 77-337, 1977-2 C.B. 305 (property acquired in a corporate liquidation immediately before exchange was not held for a qualified use).

The following cases and rulings held that the exchange qualified under Section 1031, even though the replacement property was transferred shortly after the exchange. See Magneson v. Commissioner 753 F.2d 1490 (9th Cir. 1985) (undivided interest in replacement property was immediately contributed for general partnership interest prior to the enactment of Section 1031(a)(2)(D)); Maloney v. Commissioner, 93 TC 89 (1989) (corporation liquidated and distributed replacement property to shareholders one month after exchange); Wagensen v. Commissioner, 74 TC 653 (1980) (replacement property gifted to children 9 months after exchange); Rev. Rul. 57-244, 1957-1 C.B. 247 (exchange approved even though taxpayer sold replacement property after the exchange); PLR 8126070 (March 31, 1981) (termination of trust shortly after the exchange).

Compare Rev. Rul. 75-292, 1975-2 C.B. 333 (exchange disqualified where replacement property was immediately contributed to a controlled corporation); Regals Realty Co. V. Commissioner, 127 F.2d 931 (2d Cir. 1942) (intention to hold replacement property just long enough to reduce taxes was not sufficient); Griffin v. Commissioner, 49 T.C. 253 (1967) (replacement property sold simultaneously with exchange); Bernard v. Commissioner, T.C. Memo 1967-176 (brother located buyer for replacement property 2 weeks after exchange); Black v. Commissioner, 35 TC 90 (1960) (replacement property sold 8 months after exchange); Click v. Commissioner, 78 TC 225 (1982) (replacement property used rent-free as a residence by the taxpayer's children and gifted to them 7 months after exchange).

Even replacement property that is held for a significant time period after the exchange may not qualify. See Klarkowski v. Commissioner, TC Memo 1965-328, aff'd on other grounds 385 F. 2d 398 (7th Cir. 1967) (replacement property actually held for 6 years after its acquisition, but facts indicated intention to sell quickly after the exchange); Land Dynamics v. Commissioner, T.C. Memo 1978-259 (holding of replacement property for 22 months by dealer did not evidence investment intent).

In summary, a 3-year holding period is consistent with the examples relating to a conversion of a personal residence under Treas. Reg. Section 1.165-9(c). A 2-year holding period was blessed in several private letter rulings which may not be cited as authority. A shorter holding period was allowed where the facts indicated a continued business or investment use by the taxpayer but in a different legal form. See Bolker, Magneson and Maloney, supra. These cases may not be relevant to a conversion from or to a personal residence since personal use is viewed as antithetical to business or investment use. Rather, the conversion may be treated as if it were an acquisition or disposition of the property for purposes of Section 1031 and tested in that way. See Wagnesen, Click and Regals Realty, supra.

D. **Partial Conversions**. Another planning technique is to sell part of a residence under Section 121 and exchange the remaining portion under Section 1031 after it has been converted to business or investment property. The Section 121 exclusion can be used to offset gain on the residence portion up to the $250,000 and $500,000 limits. The taxpayer may also receive more tax-

free cash due to the basis offset. The amount required to reinvest in like-kind property is reduced to the amount realized on the business or investment portion.

There is little authority relating to partial conversions. The Service has held that only a qualified business use in the year of sale requires an allocation of the sales price, selling expenses and basis. If there is no qualified business use in the year of sale, the property is treated entirely as a residence and the sale or exchange is reported solely on Form 2119. See Rev. Rul. 82-26, 1982-1 C.B. 114; Pub. 523. Gain attributable to depreciation allowable after May 6, 1997, however, must be reported as income under Section 121(d)(6).

A partial conversion to business or rental property may be effected under the above rules by actually using a portion of the property for a business or actually renting a portion of the property. Such use should be bona fide, motivated by profit and for a significant period of time before an exchange. Where the taxpayer's residence includes adjacent land, the dividing line between the personal and investment portions is unclear. Compare, e.g., Schlicher (43 1/2 acres treated as part of residence) and Bennett (jury found that 65 acres were part of residence) with Beckwith (5 acres of 80-acre tract treated as part of residence), Estate of Campbell (5.1 acres of 184 acre tract treated as part of residence), and Coupe (2 acres of 134-acre tract assumed to be part of residence). (See citations in Part IV.)

In the case of adjacent land, a partial conversion could be effected by dividing off the land from the residence and disposing of each portion in separate transactions. However, merely disposing of the land in a separate transaction will not insure that its disposition will be unrelated to the sale of the residence. A line of cases and rulings has held that a sale of a house and subsequent sale of contiguous land used as part of the residence will both be treated as a sale of the residence under Section 1034. See, e.g., Bogley v., Commissioner, 263 F.d 746 (4th Cir. 1959); Rev. Rul. 76-541, 1976-2 C.B. 246; PLR 8817015 (January 21, 1988). If the retained land has not clearly been converted to business or investment use, it should not be sold for at least 2 years after the residence is sold. The above authorities limited their holdings to sales of adjacent land within the 2-year replacement period of Section 1034. A similar result may be applicable in light of Section 121(b)(3) (limiting the exclusion to one sale every 2 years).

Other methods for selling a portion of the residence and converting the remaining portion to business or investment use have been suggested. These transactions include: (1) a sale of an undivided interest in the residence coupled with a lease of the remaining portion to the buyer; (2) a sale of the improvements coupled with a ground lease of the underlying land; and (3) a sale of the residence and contribution of the land to an investment partnership or other entity. See Henning, "Personal Residences - Planning for Tax-Free and Tax-Deferred Sales and Exchanges," Rev. of Tax'n of Indiv. (1979).

The example in Part IV involves mixed-used property. A portion of the residence was previously converted and held as investment property. In such cases, the "conversion" has already been effected and the property may be disposed in a combined sale and exchange transaction.

IV. Mixed-Use Property

A residence that has different uses in the year of the sale or exchange ("mixed-use property") requires an allocation of the selling price, selling expenses and basis. The gain or loss on each portion of the property is figured and reported separately. See Pub. 523; Instructions to Form 2119. Mixed-use property includes property which has always had different uses (e.g., as a residence and a family farm), and property where a part of the whole property has been converted to a business or investment use (e.g., the taxpayer becomes self-employed and establishes a home office in one room of a house). See "Partial Conversions" above.

The example below examines an allocation between a personal residence and the investment portion of a 30-acre property. The same rules will apply to any other case in which an allocation must be made (e.g., a farm, a qualified home office, rented rooms, an apartment building where 3 units are rented and 1 unit is lived in, and a dwelling above a business). The example is on the cutting edge and raises interesting issues about what it means to hold property for investment under Section 1031.

EXAMPLE OF ALLOCATION BETWEEN RESIDENCE AND INVESTMENT PORTION OF PROPERTY

FACTS

The taxpayer (T) interesting purchased property in Sonoma, California (the "Property") on June 1, 1976 for $230,000. The Property includes a dwelling used as T's principal residence and a rental cottage on approximately 6 acres of land. This residential part of the Property is enclosed by a wire fence separating it from the remaining land. The remaining land consists of approximately 24 acres that has been leased for grazing purposes over the years. The remaining land has never been used by T for personal, residential or recreational purposes. In the 1980's, T considered using the remaining land for a vineyard. T received cost estimates of about $650,000 to create a vineyard on the remaining land.

T's husband died on September 23, 1985. The Property was held as community property. T received a new basis in the entire Property equal to the appraised date-of-death value of $350,000. The remaining or "excess" land was valued at $180,000 as of September 23, 1985. T had not received a tentative subdivision map for the remaining land when this appraisal was made. T's home, appurtenant land and the rental studio was valued at $170,000 as of September 23, 1985.

In the early 1990's, T initiated a subdivision of the remaining land in order to maximize its value upon sale. A parcel map was prepared by an engineering firm in 1991. In 1992, the Planning Commission of the County of Sonoma approved a resolution adopting the Negative Declaration and Approving the Subdivision of the Property into four 6-acre parcels and one 6-acre remainder parcel. Thus, T received a tentative subdivision map for 4 lots of approximately 6 acres each in 1992. The "remaining parcel" shown on the subdivision map included T's dwelling unit, the rental cottage, and approximately 6 acres of land. Significant engineering and related costs were paid to obtain a tentative map.

T's home consists of approximately 1,560 square feet in a two-story wood frame and sided single family home. There are three bedrooms and one bath on the ground floor, with an additional bedroom and bath on the upper floor. The home also contains

a living room, dining room, kitchen and laundry. The 1985 appraisal report described the quality of construction and condition as "average." T has no other residence.

The rental cottage consists of a studio of approximately 600 square feet in a converted garage. The studio has been rented for $400.00 per month or $4,800 per year. In the 1985 appraisal report, $21,000 in value was allocated to the "extra" studio unit. This amount represents 12.35% of the $170,000 appraised value of the home and 6% of the $350,000 appraised value of the entire property as of September 23, 1985 (the date of death of T's husband).

The remaining land of about 24 acres has been leased for grazing purposes. T received $600 per year in grazing fees. All rental income was reported on Schedule E, Part I, of T's tax returns. This land has also been held for long-term appreciation in value. The land was not improved with roads, utilities or other improvements. T had no intention of selling the lots after the subdivision. In fact, the land was not immediately sold off as separate lots to buyers, but rather was held for appreciation in value since the subdivision in 1992.

T received a new appraisal for the Property in 1997. The appraised values were as follows:

1) "AS IS" Unimproved (Paper) Lots (4 lots) $724,000 to $744,000.

2) Single Family Home and Homesite $350,000.

The appraisal was completed after and takes into account the tentative subdivision map for the four 6-acre lots. The 1985 appraisal report simply referred to this remaining land as "excess land" since no tentative subdivision map had been obtained at that time. Obtaining a tentative map for the four 6-acre lots significantly enhanced the value and marketability of the remaining land. Under the 1985 appraisal, the "excess land" represented about 51.4% of the total appraised value ($180,000/$350,000). Under the 1997 appraisal, the four 6-acre lots represented about 67.4% ($724,000/$1,074,000) to 68% ($744,000/$1,094,000) of the total appraised value.

In April 1997, T entered into a contract to sell the entire Property for $1,105,000. The Property will be sold in one transaction to one buyer. The total sales price is very close to the 1997 appraised value of $1,074,000 to $1,094,000. Escrow will close in August 1997.

The sales contract was subject to tenants rights and provided for the buyer's assumption of the studio and grazing leases until their expiration. The contract also stated that the seller did not intend to do any work or improvements regarding the subdivision (e.g., no roads, wells, septic systems or any other items specified by the County of Sonoma to obtain a final map).

The main question is whether the entire parcel of approximately 30 acres is used as T's "residence" or whether an allocation must be made between the residence portion and the portion used for other purposes. If an allocation must be made, further questions are presented concerning the method of allocation and whether the other portion of the Property may be exchanged under Section 1031 without recognition of gain.

ISSUES

1. Is the entire 30 acre parcel used as T's residence, or is part of the Property held for business or investment purposes requiring an allocation?

2. Should the allocation be based on the relative fair market values of the residential and other portion of the Property?

3. Will the other portion of the Property qualify for nonrecognition of gain under Section 1031 if it is exchanged for like-kind property?

4. How does the new tax law affect the sale of the residence portion of the Property?

CONCLUSIONS

1). **Use of Property**. The remaining 24 acres (the 4 unimproved 6-acre lots) was not used by T as her "residence" within the meaning of Section 1034. Rather, the

remaining land was held for <u>investment</u> <u>purposes</u> within the meaning of Section 1031(a)(1). Treas. Reg. Section 1.1031(a)-1(b) provides: "*Unimproved real estate held by one other than a dealer for future use or future realization of the increment in value is held for investment*."

The facts indicate that the remaining 24 acres of land was not used as T's "residence." In <u>Stolk v. Commissioner</u>, 40 T.C. 345, 353, 355 (1963), aff'd 326 F.2d 760 (2d Cir. 1964), the Tax Court stated:

> "*The elements of residence are the fact of abode and the intention of remaining, and the concept of residence is made up of a combination of acts and intention. Neither bodily presence alone nor intention alone will suffice to create a residence. . . . The phrase 'used by the taxpayer as his principal residence' means habitual use of the old residence as the principal residence. The antithesis is nonuse of property as the principal residence.*"

The term "residence" is used in contradistinction to property used in trade or business and property held for the production of income or for investment purposes. H. Rept. 82-586 at 109 (1951), 1951-2 C.B. 357, 436; S. Rept. 82-781, Part 2, p. 32 (1951), 1951-2 C.B. 545, 566. See also <u>Thomas v. Commissioner</u>, 92 T.C. 206, 242 (1989).

The facts indicate that only about 6 acres of land including T's home was actually used as T's residence. The remaining land of about 24 acres (the four unimproved 6-acre lots) was separated from T's home by a wire fence, leased out for grazing, and never used by T for personal, residential or recreational purposes.

In similar cases, the courts have held that only about 5 acres of land surrounding the taxpayer's home constituted the taxpayer's residence. See, e.g., <u>Beckwith v. Commissioner</u>, T.C. Memo 1964-254 (5 of 80 acres held to be part of taxpayer's residence); <u>Estate of Campbell v. Commissioner</u>, T.C. Memo 1964-83 (5.1 of 183.69 acres held to be part of taxpayer's residence); <u>Lokan v. Commissioner</u>, T.C. Memo 1979-

380 (1 ½ of 7 ½ acre property used as residence). Compare Schlicher v. Commissioner, T.C. Memo 1997-37.

In Schlicher, the Service argued that the remaining land of 43 ½ acres was held for investment. However, the court found that the taxpayer used the remaining land for hiking, horseback riding and other personal purposes. Further, the taxpayer's desire to develop the other land was "abandoned when he built his current residence, and remains no more than a vague dream." Finally, the taxpayer enjoyed solitude and credibly testified that he did not purchase the property for investment purposes, but rather as a place where he could live "the rest of his life," untroubled by close neighbors.

The facts of this case are entirely different from those in Schlicher:

i. Unlike the taxpayer in Schlicher, T never used the remaining 24 acres for hiking, horseback riding or any other personal, residential or recreational purposes. Rather, T leased the land for grazing, contemplated using the land for a vineyard in the early 1980's, and then subdivided the land into four 6-acre lots in the early 1990's to maximize the value of the land.

ii. Unlike the taxpayer in Schlicher, T did not "abandon" her desire to divide the land into home sites that T could later sell for a profit. Nor was this desire "no more than a vague dream." Rather, T successfully obtained a tentative subdivision map for the remaining land at significant cost and effort. These activities were part of T's long-term holding of the land for appreciation in value.

iii. Unlike the taxpayer in Schlicher, T is not especially concerned about "solitude" or being "untroubled by close neighbors." Rather, T rents out a studio next to her home in a converted garage.

iv. Unlike the taxpayer in Schlicher, T stated that she acquired the property with the intent of using the remaining land for business or investment purposes. T's subsequent subdivision of this land, together with her holding of the land for over five years after the subdivision and the absence of any personal use of the land, is consistent

with T's stated investment intent.

Even if T had used the remaining land for residential purposes in the distant past (which T says she did not), the 1992 subdivision and subsequent holding of the land should have effected a conversion in T's holding of the remaining land for investment purposes. See Bogley v. Commissioner, 263 F.2d 746 (4th Cir. 1959), rev'g 30 T.C. 452 (1958). In Bogley, the court noted that if the taxpayers converted their holding of the remaining land, such as for investment or for trade or business, the subsequent sale of the remaining land cannot be considered a sale of the residence. In PLR 8429039 (April 17, 1984), the Service indicated that holding property as rental property for at least 2 years was a sufficient period to ensure that the Property was held for investment purposes. Here the land was held for 5 years after the subdivision in order to maximize appreciation in value when the real estate market improved.

In determining whether property is used by T as her "residence," prior regulations specifically provided that one must weigh all the facts and circumstances including the good faith of the taxpayer. Treas. Reg. Section 1.1034-1(c)(3)(i). See also Schlicher, supra; Clapham v. Commissioner, 63 T.C. 505, 508 (1975); Thomas, supra at 245. There is no reason to question T's "good faith" in stating that she held the remaining land for investment purposes. T represented that she never used the remaining land for any personal, residential or recreational purposes, and never considered or treated it as part of T's residence. This representation is supported by the facts above.

If T attempted to argue that the entire 30 acre property was used as her residence, this position could be challenged by the Internal Revenue Service based on its litigating position in other cases and the above authorities. The Service is more likely to find, and a court is more likely to hold, that the remaining land was not used as T's "residence" within the meaning of Section 121, but rather was held for "investment" within the meaning of Section 1031(a)(1). Bogley and similar cases and rulings are distinguishable because they involve adjacent land that was always part of the taxpayer's residence. See Rev. Rul. 76-541, 1976-2 C.B. 246; PLR 8817015 (January 21, 1988)

2. **Allocation**. The remaining land (the 4 unimproved 6-acre lots) was not used as your "residence" within the meaning of Section 121(a). The rental cottage was also not used as your residence. Accordingly, an allocation must be made concerning this portion of the property that was not used as your residence. The regulations under prior Section 1034 provided that:

> "*Where part of a property is used by the taxpayer as his principal residence and part is used for other purposes, an allocation must be made to determine the application of this section. If the old residence is used only partially for residential purposes, only that part of the gain allocable to the residential portion is not to be recognized under this section and only an amount allocable to the selling price of such portion need be invested in the new residence in order to have the gain allocable to such portion not recognized under this section." Treas. Reg. Section 1.1034(c)(3)(ii).*

Allocation percentages are typically used to determine the portion of the total sales price allocable to the different parts of the Property. The allocation percentages may be made based on the relative fair market values of the components of the Property. See Richards v. Commissioner, T.C. Memo 1993-422. Any reasonable allocation method may be used. See, e.g., Wigfall v. Commissioner, T.C. Memo 1982-171 (hesitating to devise allocation formula in absence of guidance from regulations, cases, or the parties); Sayre v. United States, 163 F. Supp. 495 (SD W. Va. 1958) (any reasonable allocation is permissible in connection with residence rollover under Section 1034 and exchange of business or investment property under Section 1031).

Several other cases have allocated between the residence and other portions of property using allocation percentages. See Aagaard v. Commissioner, 56 T.C. 191, 203-204 & n. 14 (1971), acq. 1971-2 C.B. 1 (25% allocation to 1 residence unit under Section 1034 and 75% allocation to 3 rental units under Section 1031); Poague v. United States, 90-2 USTC Par. 50,539 (E.D. Va. 1990), aff'd by unpublished order (4th Cir. 10-29-91)

(1/3 used for residential purposes and 2/3 used for business purposes based on square footage analysis); Gowan v. Commissioner, T.C. Memo 1975-124 (allocation between portion of property used as boarding house and portion used as personal residence); Reid v. United States, 69-2 USTC Par. 9550 (D.C. Cal. 1969) (jury verdict finding that 1/3 of ranch was used for business purposes and 2/3 was used as personal residence); Wigfall v. Commissioner, supra (allocation made between part of home used as deductible business office and part used for personal purposes); Spivey v. Commissioner, 40 T.C. 105 (1963) (12.5% of purchase price allocated to residence pursuant to the purchase contract in an installment sale); IRS Publication 523, "Selling Your Home" (25% allocation to 1 apartment unit used by taxpayer as residence and 75% allocation to 3 rental apartment units).

In this case, the allocation may be made based on the relative fair market values of the components of the Property. See Richards, supra. Based on the 1997 appraisal, approximately 1/3 of the sales price should be allocated to your personal residence, and approximately 2/3 should be allocated to the investment and rental portion of the property.

3. **Application of Section 1031.** Where one portion of a property is used as the taxpayer's residence and another portion is used for business or investment purposes, the Service has held that Section 1034 applies to the sale or exchange of the residence portion, and Section 1031 applies to a like-kind exchange of the business or investment portion. See Rev. Rul. 59-229, 1959-2 C.B. 180 (exchange of farm lands, buildings and crops for like property qualifies under Section 1031, while exchange of personal residences is treated as a separate transaction under Section 1034).

In Sayre, supra, the taxpayer exchanged a farm and residence worth $81,200 and $9,000 respectively. The taxpayer received a new farm worth $75,000 and $15,200 in cash or boot. The taxpayer also acquired a new residence costing more than $9,000. Ordinarily, gain on a Section 1031 exchange is taxable to the extent of the cash or boot received. However, the court agreed with the taxpayer that $9,000 of the cash received

was a payment for the old residence and more than that amount had been reinvested in a new residence under Section 1034. Thus, only $6,200 in gain was recognized on the exchange under Section 1031(b) ($81,200 value of old farm less $75,000 value of new farm). See also Treas. Reg. Section 1.1031(j)-1 (requiring matching of like-kind properties in one exchange group and recognition of gain only to the extent of any "exchange group deficiency").

In Coupe v. Commissioner, 52 T.C. 394 (1969), acq. in result only, 1970-1 C.B. xv, Section 1031 applied to the like-kind exchange of surrounding land, and Section 1034 applied to the rollover of the taxpayer's residence into a new residence. The residence in Coupe consisted of the taxpayer's house and about 2 acres of land immediately surrounding the house. The balance of the property consisted of about 132 acres of land. The taxpayer exchanged the land for other land and also received cash boot. The taxpayer recognized gain on the exchange only to the extent of the boot received.

Other cases and rulings have applied a functional division of the property where it has different uses. See Aagaard, supra (exchange of rental portion of apartment building allowed, but taxpayer traded down in value and had to recognize gain due to the boot received); Rev. Rul. 79-261, 1979-2 C.B. 292 (allocation made for purposes of Section 1033 between owner-occupied and tenant-occupied portions of an office building); G.C.M. 3789 (March 21, 1979)(discussing "functional division" of property). See also Hughes v. Commissioner, 71-2 USTC par. 9687, n. 4 (4th Cir. 1971) (Haynsworth, C.J., dissenting).

Based on the above cases and rulings, T may exchange the other portion of the Property held for investment under Section 1031. The enactment of Section 121 and repeal of Section 1034 should not affect this conclusion. The exchange part of the transaction must satisfy all of the rules applicable under Section 1031, including (without limitation) the exchange requirement, the 45-day property identification requirement and the 180-day property receipt requirement. Through a valid exchange,

the equity in this portion of the Property must be reinvested in like-kind replacement property of equal or greater value. For example, if approximately 2/3 of the sales price is allocable to the investment property (e.g., approximately $690,000 after selling expenses), T must receive replacement property worth $690,000 or more. To the extent that T trades down in value or equity, T will recognize gain on the exchange.

Section 1031 continues to have broad like-kind rules. See Treas. Reg. Section 1.1031(a)-1(b), (c). Under these rules T may exchange the unimproved land for improved property, including an apartment building, office building or other real estate held for business or investment purposes. See, e.g., Rev. Rul. 72-515, 1972-2 C.B. 466; Barker v. Commissioner, 74 T.C. 555 (1980), Burkhard Inv. Co. v. United States, 102 F.2d 642 (9th Cir. 1938) (commercial building for lots); Braley v. Commissioner, 14 B.T.A. 1153 (1929) (city real estate for a ranch or farm); Rutland v. Commissioner, T.C. Memo 1977-8. An administration proposal that would have restricted the like-kind standard under Section 1031 was not enacted as part of the new tax law.

4. **Application of New Tax Law**. Based on the above cases and rulings, the sale of the residence portion of the Property is treated as a separate transaction. Section 121 does not purport to change this result. For example, Section 121(d)(5)(B) allows the exclusion to apply in cases where the balance of the gain is deferred under Section 1033 in an involuntary conversion of a principal residence.

The new tax law applies to this sale of T's principal residence. Effective for transactions on or after May 7, 1997, single taxpayers can exclude from income up to $250,000 ($500,000 if married filing jointly) in gain from the sale or exchange of their principal residence. This is a permanent exclusion, not just a deferral or rollover of gain until a later time. Moreover, there is no reinvestment requirement.

The new gain exclusion replaces the gain rollover rule under Section 1034. Thus, gain in excess of $250,000 ($500,000 if married filing jointly) must be included in income even if all of the sales proceeds are reinvested in a new residence. The new gain exclusion also replaces the one-time $125,000 exclusion available to individuals age 55

or older. To qualify for the exclusion, the taxpayer must have owned and used the property as the taxpayer's principal residence for at least two of the five years preceding the sale.

If, pursuant to the 1997 appraisal, approximately 1/3 of the sales price is allocable to T's principal residence (e.g., approximately $345,000 after selling expenses), T's gain on the residence will be approximately $196,000 ($345,000 less $149,000 basis). The basis in T's residence is based on the appraisal report for the Property as of September 23, 1985 when T's husband died and T received an increased basis equal to the fair market value at date of death. The entire Property was valued at $350,000, with $180,000 allocable to the 24 acres of "excess land" and $21,000 allocable to the "extra" studio unit. A total of $149,000 was allocable to T's principal residence ($350,000 less $180,000 less $21,000). Thus, is T's tax basis in the portion of the Property used as T's principal residence, is $149,000, and T's gain on sale will be approximately $196,000 ($345,000 amount realized less $149,000 basis). Under the new tax law, all of the gain allocable to T's principal residence will be excluded up to $250,000, regardless of whether or not T reinvests in a new residence.

V. Conclusion

The techniques suggested above work for any real estate. With planning, patience and some temporary inconvenience, gain on the disposition of any real estate may be minimized, excluded, deferred and avoided.

Example. T owns a commercial office building with $5 million of gain. T exchanges the office building for 2 luxury homes to be rented out for a significant time and held for investment. Two or three years after the exchange, T and his family (total of four persons) moved into one of the homes and occupy it as their principal residence. At the time they move in, T and his wife are engaged in estate planning. They give an undivided interest in the home to their two children using up part or all of their unified credit. The family owns and uses the property as their principal residence for 2 years. The home is then sold and $1 million of gain is excluded. Through a Section 1031

exchange, a conversion of the property and the use of the Section 121 exclusion, T cashes out of his investment and $1 million of gain attributable to a commercial office building is excluded from income.

Have you heard about the man who got a bill from his tax lawyer which said, “For crossing the street to speak with you and discovering it was not you . . . . fifty dollars”? In contrast, the interplay between Sections 121 and 1031 is one area where tax lawyers may earn their keep.