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Exchange props. and combine business and residence use

June 24, 2009 - Front Section

IRC Section 1031 offers significant tax advantages by allowing an owner of business or investment use property to defer capital gain when exchanging such property for like kind property that will be held for business use or for investment. Section 121 of the code allows the owner of a principal residence to exclude capital gain realized on the sale or exchange of his or her property. The exclusion is limited to \$250,000 (\$500,000 for certain joint returns).

It's important to remember that both provisions may apply in a single like kind exchange, allowing the knowledgeable investor/owner to take advantage of both tax deferral (Â§1031) and tax exclusion (Â§121)! Several years ago the IRS issued Revenue Procedure 2005-14 to provide a roadmap for such transactions. Two common scenarios: (1) a single property is used first as the taxpayer's principal residence, then converted to business use, and then transferred as "relinquished" property in a like-kind exchange, and (2) separate portions of a single structure are used independently, one as a principal residence and the other for business or investment use, prior to the transfer of the entire property in a Â§1031 exchange (mixed use). Mixed use examples include a single dwelling used for a residence and home office; separate residence and business structures on the same property; and owner-occupied, multi-unit rental properties.

We first ask whether the relevant holding period requirements are satisfied. As to Â§121: did the taxpayer own and use the house as his principal residence for at least 2 years of the 5-year period preceding the date of the exchange? As to Â§1031: at the time of the exchange, was the taxpayer then holding the property for a trade or business use?

Assuming each answer is yes, we then look to the revenue procedure. First, before applying Â§1031, the Â§121 exclusion is to be applied to gain from the transaction. Second, when determining the gain to be deferred under Â§1031, the Â§121 exclusion should be applied first against amounts received by the taxpayer that would ordinarily constitute "boot" in a like-kind exchange. With respect to the business or investment portion of a residence, the Â§121 exclusion will not apply to gain attributable to depreciation deductions for periods after May 6, 1997, although Â§1031 may be applied to such gain.

Example: Ted buys a house for \$210,000 that he uses as his principal residence from 2000 to 2004. From 2004 until 2006 Ted rents the house and claims depreciation deductions of \$20,000. In 2006, Ted exchanges the house for \$10,000 of cash and a townhouse with a fair market value of \$460,000, intended for rental purposes.

Analysis: Ted satisfies the holding period requirements under both Â§121 and Â§1031. He receives consideration of \$470,000 (cash plus FMV of the townhouse). His "realized gain" is the \$470,000 less his adjusted basis (\$190,000), or \$280,000. First, we exclude gain under Â§121 up to the allowed limit of \$250,000. The \$30,000 balance of the gain may be deferred under Â§1031. Note that, in this example, the portion of the gain attributable to the depreciation is being deferred under

Â§1031. Also, the \$10,000 cash received by Ted will not constitute taxable boot as it is deemed attributable to the gain amount excluded under Â§121 and not to cash boot under Â§1031.

Applying the rules becomes more complex for mixed use properties. There are many examples that work through issues of allocating gain, determining taxable "boot" and resulting tax basis. Our Â§1031 clients with "converted use" or "mixed use" commercial properties regularly consult with their tax advisors to determine if they are candidates for this powerful combination of benefits.

Edward Zaval, Esq., is New England Exchange Counsel for Investment Property Exchange Services, Inc. (IPX), Boston, Mass.

New England Real Estate Journal - 17 Accord Park Drive #207, Norwell MA 02061 - (781) 878-4540