

Exit strategies and tax planning of mixed and "dual" use properties.

Congress and the Internal Revenue Service have offered guidance with regard to several outstanding issues and strategies involving IRC section 1031 exchanges and IRC Section 121 principle residence exclusions.

Section 121(a) provides that a taxpayer may exclude gain realized on the sale or exchange of a property if the property was owned and used as the taxpayer's principle residence for at least 2 years during the 5 year period ending on the date of the sale or exchange. The exclusion is limited to the higher of the gain or \$250,000 (\$500,000 for qualifying joint filers). Any depreciation taken on the property(ies) since May 6, 1997 does not qualify for the exclusion.

The American Jobs Creation Act of 2004, was signed into law on October 22, 2004 by President Bush, it contains a provision that profoundly affects code section 1031 and the relation to code section 121. This legislation included the following provision to amend section 121(d);

(10) PROPERTY ACQUIRED IN LIKE-KIND EXCHANGE. - If a taxpayer acquired a property in an exchange to which section 1031 applied, subsection (a) shall not apply to the sale or exchange of such property if it occurs during the 5 year period beginning with the date of acquisition of such property.

Now, if a taxpayer acquires through an exchange a rental property which is subsequently converted into a primary residence this property does not qualify for section 121 exclusion until the property has been held for at least 5 years and meets the 2 out of 5 year occupancy test.

Although this legislation is more restrictive than previous interpretations, it now offers statutory authority for this type of transaction. It was thought by some that this could be accomplished within as little as three years, however, now we have a quasi safe harbor to these situations.

EXAMPLE: John Q. sold a multi-unit rental on May 1, 2003. All requirements of T. Reg 1.1031 were met and the property was replaced October 15, 2003. The taxpayer moves into the replacement property November 15, 2005 and intends to occupy it as his primary residence. Under the new law, although the 2 year occupancy test is met November 15, 2007, the taxpayer will need to wait till October 15, 2008 for this property to qualify for the section 121 exclusion.

The purpose of Revenue Procedure 2005-14 is to provide guidance on the application of sections 121 and 1031 to a single sale or exchange of property. The scope applies to taxpayers who exchange property that qualifies for both sections 121 and 1031 in a single transaction.

The gain is computed in the following order:

1. Application of the section 121 exclusion before section 1031 is applied.
2. Application of 1031 gain attributable to depreciation taken after May, 6 1997. This does not qualify for section 121 exclusion; however, section 1031 may apply to such gain.
3. Boot, Cash or non-qualifying property is taxable only to the extent it exceeds the section 121 exclusion.

This revenue procedure offers several very specific examples of the application of sections 121 and 1031 in various situations beyond the scope of this article. In general the following is a synopsis of the situations specifically addressed in these examples.

Example 1- This example shows the application in the case of a taxpayer that acquired a

principle residence which is occupied for two years and converted into a rental and subsequently sold. The taxpayer qualified for the section 121 exclusion and 1031 exchange. The gain is in excess of the exclusion and cash boot is paid.

Practical application- A client with a primary residence with a gain well in excess of the exclusion may wish to convert to rental for a period of time (2-3 years in this example) before selling the property to receive the entire 121 exclusion and also the application of section 1031 on the remainder.

Example 2- This example illustrates the situation where a taxpayer acquires a primary residence with an outbuilding/guesthouse that is used in a trade or business. This stipulates the allocation that is to be made in this situation and what is attributed to section 121 and what qualifies for section 1031.

Examples 3- This example examines the effect of a mixed use property. In this case 1/3 of the property was used for business and 2/3 of the property was used as a primary residence. Again this demonstrates the use of sections 121 and 1031. These examples also illustrate the effect of cash boot and taxability of gain allocated in excess of the section 121 exclusion.

The applicability of these strategies is truly unbelievable. Whenever a taxpayer is considering selling real estate, these goals and objectives must be considered before closing. If selling an investment, business, or rental property, the taxpayer must consider 1031 and reconcile their goals with the available strategies. This has always been the mantra of 1031 intermediary companies throughout the country and now more than ever, the applicability of 1031 has to be, at a minimum, given adequate consideration.

Now this has been extended by revenue procedure 2005-14 to include residential properties. Is this procedure applicable, or can it be made applicable with some planning? These are the new questions taxpayers have to ask themselves.

Kim T. Schooley, CPA, CES