Chapter 4: Tax Aspects of Home Ownership

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Corrections were made to this workbook through January of 2011. No subsequent modifications were made.

FIRST-TIME HOMEBUYER CREDIT

BACKGROUND OF CREDITS

The first-time homebuyer credit is a work in progress for Congress. Since the initial bill, the credit has been modified three times.

The credit was first introduced in the Housing Assistance Tax Act of 2008.[1] Qualified individuals purchasing a principal residence after April 20, 2008, and before July 1, 2009, were eligible for the credit if they had not had an ownership interest in a principal residence during the three years preceding the date of the purchase of the new residence. If the individuals were married, both spouses were required to meet the 3-year test. The maximum credit was 10% of the purchase price or $7,500, whichever was less.

If the house was purchased in 2009, the credit could be carried back and claimed on a 2008 return, or claimed on a 2009 return. However, the passage of a subsequent first-time homebuyer credit bill made taking this $7,500 credit in tax years beyond 2008 illogical. While this was termed a "credit," it was essentially a 15-year interest-free loan. The first installment of the repayment of the credit was due in the second year following the year the credit was claimed. Thus, for home purchases made in 2008, the first payment is due in 2010 for calendar-year taxpayers, unless repayment is accelerated. If the house ceases to be the principal residence before the end of the 15-year period, the remaining credit is recaptured in that year.

Caution. The practitioner should exercise due diligence when preparing the 2010 tax return to ensure that the first required repayment of the 2008 credit is not overlooked.

Note. If the house is sold to an unrelated taxpayer, the amount of recapture is limited to the amount of gain realized on the property.

The American Recovery and Reinvestment Act of 2009[2] extended the credit for purchases of homes. To qualify, homes must have been purchased no later than November 30, 2009. It also increased the credit to a maximum amount of $8,000 and, more significantly, waived the repayment provision for homes purchased in 2009. Recapture of the credit, however, is required if the taxpayer disposes of the principal residence or if the home ceases to be the principal residence of the taxpayer within 36 months of the date of purchase. The bill also allows the taxpayer to claim the credit on the 2008 return.

1. P.L. 110-289.
2. P.L. 111-5.

Note. Taxpayers who purchased qualifying residences in 2009 and elected to claim the purchase in 2008 are not subject to the $7,500 limit or 15-year repayment of the credit. However, the bill did not eliminate the repayment provisions for 2008 purchasers.

The Worker, Homeownership, and Business Assistance Act of 2009[3] signed into law on November 6, 2009, made two major changes to the credit. First, it extended the $8,000 credit to purchases made either before May 1, 2010, or before July 1, 2010, if the taxpayer had entered into a binding written contract before May 1, 2010. Second, the bill also created a new class of homebuyers eligible for the credit — long-time residents of the same main home. These taxpayers are eligible for a credit up to $6,500 if they owned the same principal residence for any five consecutive years during an 8-year period ending on the date of purchase. The existing-homeowner provision is effective for purchases after November 6, 2009.

The bill also added the following provisions, all of which are effective for purchases after November 6, 2009:

- No credit is allowed for home purchases if the purchase price exceeds $800,000.
- The homebuyer must have attained age 18 as of the date of purchase unless the taxpayer is married and the spouse is age 18 or older.
- No credit is allowed if the taxpayer is claimed as a dependent on another taxpayer's return for the tax year of purchase.
- The taxpayer must attach a copy of any required statements to their 2009 or 2010 tax return.[4]
- An expanded definition of a related party now includes persons related to the taxpayer's spouse.
- There are increased income limits for qualification of the credit based on the table below.

First-Time Homebuyer Credit Modified Adjusted Gross Income (MAGI) Phaseout Range

	Date of Purchase	
Filing Status	**January 1, 2009 to November 6, 2009**	**November 7, 2009 to April 30, 2010**
MFJ	$150,000–170,000	$225,000–245,000
All others	75,000–95,000	125,000–145,000

Observation. Taxpayers can elect to treat a home as purchased on December 31 of the preceding tax year. Consequently, 2009 purchases can be claimed as a credit on the 2008 return and 2010 purchases on the 2009 return. This can be useful when taxpayers exceed the MAGI income range or wish to accelerate receipt of the refund. Electing to do this does not make the taxpayer subject to other limits or recapture provisions for earlier years, as the date of purchase dictates application of the law.

3. P.L. 111-92.

4. Instructions for Form 5405, *First-Time Homebuyer Credit and Repayment of the Credit.*

REPAYMENT AND RECAPTURE OF FIRST-TIME HOMEBUYER CREDIT

The rules for repaying or recapturing the credit differ depending on when the home was purchased, not the year the credit was claimed.

For homes purchased in 2008, the credit must be repaid in 15 equal installments from 2010 to 2024. The repayment amount is included as an additional tax on the taxpayer's income tax return for those years. This normally is $500 per year, assuming the taxpayer was originally entitled to a $7,500 credit. The exceptions to the repayment rule are as follows:

- If the taxpayer dies, the surviving spouse is required to repay only their half of the remaining repayment amount. The deceased spouse's remaining annual installments are waived, including amounts due originally in the year of death.
- For homes transferred between spouses or ex-spouses incident to a divorce, the transferee spouse is responsible for any remaining repayment for tax years ending after the transfer.
- For homes sold, the remaining repayment amount becomes due in the year of sale. Repayment is limited to the amount of gain on a sale to an unrelated taxpayer. The basis of the home is reduced by the credit claimed and then increased by the amount of credit repaid. If there is a loss on a sale to an unrelated party, remaining installments are eliminated.
- If the home ceases to be the principal residence of the taxpayer, all remaining annual installments become due on the return in the year the conversion of the residence occurs. This includes situations in which the residence becomes a secondary residence (vacation home), rental property, or business property.
- Accelerated recapture does not apply if the residence is involuntarily converted and the taxpayer acquires a new principal residence within two years under IRC §1033. However, accelerated recapture applies to the new residence as if the new residence were the converted residence.

If a taxpayer and spouse claim the credit on a joint return, each spouse is treated as having been allowed half the credit for purposes of repaying the credit.

Repayment of the credit is not offset by nonrefundable credits of the taxpayer in future tax years.

Example 1. Mindy and Mike purchased a home in 2008 and qualified as first-time homebuyers. Mike's employer transfers him to an out-of-state location and they sell the residence on November 1, 2010. Therefore, they must file Form 5405, *First-Time Homebuyer Credit and Repayment of the Credit,* and recapture the first-time homebuyer credit. The home cost $160,000, and the net proceeds from the sale were $155,000. The recapture is computed as follows:

Sale price		$155,000
Purchase price	$160,000	
First-time homebuyer credit	(7,500)	
Basis in residence	$152,500	(152,500)
Gain realized		$ 2,500
Credit recapture (lesser of credit or gain realized)	$ 2,500	

For Example 1

Form 5405 (Rev. 12-2010) Page 2

Note. Skip this page if you are not filing this form to (1) report a disposition or change in use of your main home for which you claimed the credit in 2008 or 2009, or (2) pay an installment of the credit you claimed for a home purchased in 2008.

Name(s) shown on return	Your social security number
Mike and Mindy Homebuyer	333-33-3333

Part III Disposition or Change in Use of Main Home for Which the Credit Was Claimed

11 Enter the date you disposed of, or ceased using as your main home, the home for which you claimed the credit (MM/DD) . . . ▶ 11/01 / 2010

12 If you meet the following conditions, check here . . . ▶ ☐
I (or my spouse if married) am a member of the uniformed services or Foreign Service, or an employee of the intelligence community. I sold the home, or it ceased to be my main home, in connection with Government orders for qualified official extended duty service. No repayment of the credit is required (see instructions). Stop here.

13 Check the box below that applies to you. See the instructions for the definition of "related person."

a ☑ I sold (including through foreclosure or repossession) the home to a person who is not related to me and had a gain on the sale (as figured after reducing the basis of my home by the credit I claimed in 2008 or 2009). Go to Part IV below.

b ☐ I sold (including through foreclosure or repossession) the home to a person who is not related to me and did not have a gain on the sale (as figured after reducing the basis of my home by the credit I claimed in 2008 or 2009). No repayment of the credit is required. Stop here.

c ☐ I sold the home to a related person. Go to Part IV below.

d ☐ I converted the entire home to a rental or business use OR I still own the home but no longer use it as my main home. Go to Part IV below.

e ☐ I transferred the home to my spouse (or ex-spouse as part of my divorce settlement). The full name of my ex-spouse is ▶

The responsibility for repayment of the credit is transferred to your spouse or ex-spouse. Stop here.

f ☐ My home was destroyed, condemned, or disposed of under threat of condemnation and I acquired or plan to acquire a new home within 2 years of the event.

- For homes purchased in 2008, repayment of the credit over a 15-year period begins with your 2010 tax return. Check box b on line 16. If you purchase a new home within 2 years of the event, your annual payment requirement does not change.
- For homes purchased in 2009 or a later year, you may not have to repay the credit (see instructions).

g ☐ My home was destroyed, condemned, or disposed of under threat of condemnation and I do not plan to acquire a new home within 2 years of the event (see instructions).

h ☐ The taxpayer who claimed the credit died in 2010. No repayment of the credit is required of the deceased taxpayer. If you are filing a joint return for 2010 with the deceased taxpayer, see instructions. Otherwise, stop here.

Part IV Repayment of Credit Claimed for 2008 or 2009

14	Enter the amount of the credit you claimed on Form 5405 for 2008 or 2009. See instructions if you filed a joint return for the year you claimed the credit. If you checked box 13a above, go to line 15. Otherwise, skip line 15 and go to line 16 . . .	14	7,500
15	Enter the gain on the sale of your main home (as figured after reducing your basis by the amount on line 14 above) (see instructions) . . .	15	2,500
16	Check the box below that applies to you. (Check only one box.) a ☑ I am reporting a disposition or change in use of my main home. If you checked box 13a above, enter the smaller of line 14 or line 15. Otherwise, enter the amount from line 14. b ☐ I am paying an installment of the credit I claimed for a home purchased in 2008. Divide line 14 by 15.0. This is the minimum amount you must repay with your 2010 return. Enter this amount (or a larger amount if you choose) here. (see instructions) . . .	16	2,500

Next: Include the amount from line 16 on your 2010 Form 1040, line 59, or Form 1040NR, line 58. Check the "Form 5405" box on that line.

Form **5405** (Rev. 12-2010)

For homes purchased in 2009 or 2010, the credit does not have to be repaid unless the residence is sold or the taxpayer stops using the home as the principal residence within 36 months, beginning on the date of purchase. The credit is recaptured (repaid) in the year of sale or conversion to other use. If the home is sold to an unrelated person, the repayment is limited to the gain on the sale.

The recapture provisions are waived for qualified military personnel and certain government employees. They must have either sold or stopped using their home as a principal residence after December 31, 2008, as a result of government orders for qualified official extended-duty service received by the taxpayer or spouse.

The Homebuyer Assistance and Improvement Act of 2010,[5] signed into law on July 2, 2010, extended the closing date from June 30, 2010 to September 30, 2010 for qualified home purchases with agreements entered into before May 1, 2010. No other changes to, or requirements for, the credit were made.

5. P.L. 111-198.

HOME MORTGAGE INTEREST DEDUCTION

BACKGROUND

In 1894, mortgage interest was first allowed as a deduction on income tax returns. All other forms of interest were also deductible. Income taxes were later eliminated altogether when the Supreme Court ruled that the income tax was unconstitutional. However, the Constitution was subsequently amended, and in 1913 a new income tax return was created that allowed deductions for all types of interest. The Tax Reform Act of 1986[6] eliminated the deduction of personal interest and narrowed the home mortgage interest deduction.

> **Note.** The first U.S. income tax was imposed in 1862 and then abolished in 1872. Income tax was then imposed again in 1894 and 1895 before it was again abolished. Income tax became a permanent fixture in the United States in 1913 with the passage of the 16th amendment.

Mortgage debt has grown dramatically in recent years. There has also been substantial debt refinancing. Presently, 40 million taxpayers claim the mortgage interest deduction, saving taxpayers approximately $80 billion per year in federal income taxes.[7] The tax policies regarding the deduction of mortgage interest are currently being reviewed by the administration as to their effectiveness. Shaun Donovan, Secretary of the Department of Housing and Urban Development (HUD) stated it might make sense to modify the mortgage interest deduction.[8]

Congress requested that the General Accounting Office (GAO) study the issue because of complexities being presented to taxpayers and the likelihood that taxpayers are becoming increasingly noncompliant. Complexities surround the limitation on the amount of interest that can be deducted, special rules on refinancing, alternative minimum tax (AMT) considerations, and deductions of prepaid interest amounts (points). The GAO, based on its findings, made a number of recommendations.[9] These include:

- Revising the IRS audit selection system so that a tax return's mortgage interest deduction is not automatically excluded as an examination issue just because it matches the information reported on Form 1098;
- Expanding information on Form 1098 to include the mortgage balance, current-year refinancing, and the address of the home securing the mortgage; and
- Revising Form 1040, Schedule A, *Itemized Deductions.*

The GAO also reviewed three tax preparation software packages and found they differed on how they treated deduction limitations.

CURRENT LIMITATIONS

Interest limitations exist for mortgages and/or home-equity debt taken out after October 13, 1987. Mortgages incurred before this time are grandfathered debt and have no limitations. The deduction is limited to the interest on $1 million ($500,000 for married filing separately (MFS) taxpayers) of nongrandfathered debt used to buy, build, or improve a **qualified home.** Home-equity interest is limited to the debt on the smaller of:

- $100,000 ($50,000 MFS), or
- The fair market value (FMV) of the home reduced by the mortgage debt or home-acquisition indebtedness.

6. P.L. 99-514.
7. GAO-09-769, *Home Mortgage Interest Deduction* (July 29, 2009).
8. *Time.com.* Kiviat Barbara. "Are We Going to Get Rid of the Mortgage Interest Deduction?" May 17, 2010. [www.time.com] Accessed on July 22, 2010.
9. GAO-09-769, *Home Mortgage Interest Deduction* (July 29, 2009).

The dollar limit for the above categories applies to the combined mortgages on the taxpayer's qualified principal residence and second home.

Example 2. Gunter borrows $250,000 on a home-equity line of credit and uses $125,000 for remodeling the home and the remaining amount to purchase an automobile and pay college tuition. The FMV of the home is greater than $250,000 and the interest incurred on the loan in the first year is $17,500. Gunter reports the interest as follows:

	Debt	Interest
Fully-deductible home mortgage interest (amount used for remodeling)	$125,000	$ 8,750
Fully-deductible home-equity debt (amount not exceeding $100,000)	100,000	7,000 [a]
Deductible home mortgage interest		**$15,750**

[a] ($100,000 ÷ $125,000) × $8,750 = $7,000

Qualified homes for the above limitations are the taxpayer's principal residence and a secondary residence that can be chosen by the taxpayer. If the second home is not a rental, there is no taxpayer-use requirement. If rented, it must be used as the taxpayer's home for the **longer of 14 days or more than 10% of the number of days it is rented**. If a taxpayer has more than two homes, he can choose which home is his second home each year. Within a year, the taxpayer is allowed to designate a different second home if:

- He acquires another home during the year,
- The principal residence is converted to a second home during the year, or
- The second home becomes his principal residence.

A qualified home includes a house, condominium, cooperative, mobile home, house trailer, boat, or similar property that has sleeping, cooking, and toilet facilities.

SECURED DEBT

Mortgage interest is deductible only if the mortgage is secured debt. In order to qualify as secured debt, the qualified home must be security for the payment, the debt must be recorded or perfected under state law, and in the case of default, the home could satisfy the debt. Mortgage interest relative to purchasing stock in a cooperative housing corporation qualifies as long as the proceeds of the mortgage were used to purchase the stock.

In some situations, taxpayers may claim the mortgage interest deduction even though they are not legally liable for the loan. Treas. Reg. §1.163-1(b) states:

> *. . . Interest paid by the taxpayer on a mortgage upon real estate of which he is the legal or equitable owner, even though the taxpayer is not directly liable upon the bond or note secured by such mortgage, may be deducted as interest on his indebtedness.*

CONSTRUCTION LOANS

If a taxpayer constructs a home and/or purchases a lot, the interest is qualified residence interest if the following requirements are met:

1. The house must be used as a principal residence or secondary home at the end of the construction period.
2. Loan proceeds have to be directly traceable to construction expenses or purchase of the lot.
3. Construction interest is qualifying home mortgage interest for up to 24 months from the start of construction to occupancy. If the construction period is longer than 24 months, the remaining months' interest is considered personal interest.
4. Construction expenses incurred in the 24 months before construction is completed are applied toward the $1 million limit on home-acquisition debt.

When a taxpayer incurs and deducts construction interest on a home as qualifying home mortgage interest and decides after the construction is complete to sell the property without occupying the home as a residence, he must restate mortgage interest as investment interest and amend prior returns.

REFINANCED DEBT

Interest on new mortgage amounts equal to prior refinanced balances of acquisition debt or grandfathered debt remain tax deductible. Refinanced amounts in excess of prior outstanding debt can be acquisition debt to the extent that they are used for new improvements, home-equity debt subject to the $100,000 limitation, or nondeductible home mortgage interest.

POINTS

Amounts charged to a borrower to obtain a home mortgage may be called points, loan-origination fees, maximum loan charges, loan discount, or discount points. They are either deducted in full in the year paid or amortized over the life of the loan. Points are deductible in the year paid if all the following conditions are met:

- The loan is used to buy or build the taxpayer's principal residence and is not in excess of $1 million.
- The points are paid from either the borrower's funds or the seller's funds.
- The loan is secured by the taxpayer's principal residence.
- The points paid are a percentage of the mortgage and not in place of other charges normally stated separately such as title fees, appraisal fees, and so on.

> **Observation.** Even if a taxpayer is allowed to deduct all the points in the current tax year, he can elect to amortize them over the life of the loan. This situation could occur when the taxpayer purchases a home late in the year and does not itemize deductions.

Points paid to refinance a mortgage on a principal residence must be amortized over the life of the new loan if the new loan proceeds were not used to substantially improve the principal residence.

Points on mortgages replaced by refinancing (unamortized amounts) can be deducted currently, provided the same lender was not used for the refinancing.

Points on the following types of mortgages are not currently deductible:

- Home-equity loans **not** used to improve the principal residence
- Financing on secondary residences
- Refinancing loans on a principal residence that are not used for improving the home
- The portion of a mortgage loan that exceeds $1 million
- Loan periods in excess of 30 years (also not deductible ratably)

ALTERNATIVE MINIMUM TAX (AMT) CONSIDERATIONS

Mortgage-interest deductions are narrower for AMT calculations. Thus, not all interest on Schedule A is deductible for AMT purposes and may be added back on line 4 of Form 6251, *Alternative Minimum Tax — Individuals*, if required. The IRS clarified that qualified acquisition indebtedness that is refinanced more than once is deductible for AMT purposes to the extent the amount of the loan is not increased. Home-equity loan interest ($100,000 limit) not used to improve the qualifying residence is not deductible for AMT purposes. Neither is any other indebtedness on secondary residences which are not real estate such as mobile homes, motor homes, or boats.

> **Example 3.** Margot purchased a residence for $200,000 and financed the acquisition with $40,000 cash and a $160,000 mortgage. Several years later when the mortgage balance is $120,000, she refinances the home for $150,000. She does not use the $30,000 excess to improve the home. Although the interest on the excess $30,000 debt is deductible for regular tax purposes as home-equity interest, it is not deductible for AMT purposes.

ELECTION TO TREAT DEBT AS NOT SECURED BY A QUALIFIED RESIDENCE

Taxpayers can be subject to limitations on the deduction of mortgage interest for regular tax and/or AMT. To the extent the proceeds of a loan are used for a business, the taxpayer can make an election under Temp. Treas. Reg. §1.163-10T(o)(5)(i) to treat the debt as not secured by a qualified residence, and thus claim a deduction on Schedule C, *Profit or Loss from Business*. This election, if made, is effective for all subsequent years.

REVERSE MORTGAGES

Reverse mortgages are an alternative for senior homeowners needing access to the equity in their homes. To qualify, seniors must be at least age 62 and have equity in their homes. A reverse mortgage allows individuals to convert the equity in their homes to cash. The homeowner may receive a lump-sum amount, a line of credit, or monthly payments over a fixed or lifetime period. The amounts received are proceeds from a mortgage loan and thus are not taxable. Interest is not paid until the loan is repaid because interest is added to principal throughout the loan period.

No credit checks are required to obtain these loans, and there is no requirement to repay the loan as long as the senior lives in the home. The amount that can be borrowed is dependent on the homeowner's age, current interest rates, and the appraised value of the home.

When the homeowner dies or moves out of the residence permanently, the homeowner or estate usually has 12 months to repay the balance of the reverse mortgage or sell the home and repay the loan. The homeowner or estate is not liable for any difference if the home sells for less than the balance of the reverse mortgage.

There are three main types of reverse mortgages:

1. Single-purpose reverse mortgages are offered by governmental or nonprofit lenders. These are limited as to purpose of use, are not available everywhere, and usually have the lowest fees associated with them.
2. Federally-insured reverse mortgages or home-equity conversion mortgages (HECMs) are backed by HUD. These mortgages can have high upfront fees and tend to be more expensive than traditional mortgages. They can be used for any purpose and are widely available.
3. Proprietary reverse mortgages are written and backed by private companies that offer them. These tend to have high fees and can be used for any purpose.

Additional information on these types of mortgages can be obtained at the following websites:

- Reverse Mortgage Education Project: **www.aarp.org/revmort**
- U.S. Department of Housing and Urban Development: **www.hud.gov/offices/hsg/sfh/hecm/hecmhome.cfm**
- Federal Trade Commission: **www.ftc.gov/bcp/menus/consumer/credit.shtm**

FORECLOSURES, ABANDONMENTS, SHORT SALES, AND LOAN MODIFICATIONS

Note. Terms used in this section include:

- **Foreclosure**. The legal process used by a lender to terminate the borrower's right of redemption to the property.
- **Abandonment.** The relinquishment of the property.
- **Short sale**. A sale of real estate in which the sale proceeds are less than the balance owed on the property's loan.
- **Deed in lieu of foreclosure.** A transfer of a delinquent loan property deed to the lender.
- **Voluntary conveyance.** This term means the same as deed in lieu of foreclosure.

Many homeowners face delinquencies on their mortgage obligations due to high unemployment and the decline in value of residential real estate. Many of these mortgages will not be paid in full. Consequently, tax practitioners must address the income tax consequences of these situations and advise clients of the consequences of their actions. Whether a taxpayer goes through foreclosure, abandonment, short sale, or voluntary conveyance, the result is a deemed sale of the residence for income tax purposes. In addition, it is necessary to determine whether the taxpayer has any cancellation-of-debt income (CODI) and how it will be reported on the tax return. Sales of principal residences are reported on Form 1040, Schedule D, *Capital Gains and Losses*. Gains may be excluded under IRC §121 and losses are generally nondeductible personal losses under IRC §165(c). These situations must be reviewed to determine whether the taxpayer has CODI and whether it is taxable income or excluded and reported on Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment).*

The deemed sales price of the property in these situations depends on whether the borrower is personally liable (recourse debt) or not (nonrecourse debt) for the mortgage debt. This is reported on either Form 1099-A, *Acquisition or Abandonment of Secured Property,* or 1099-C, *Cancellation of Debt*, issued to the taxpayer. The taxpayer's personal liability depends on state laws and whether the lender pursues remedies through judicial or nonjudicial foreclosure. The deemed sales price is determined as follows:

- Nonrecourse debt = Balance of loan outstanding
- Recourse debt = Lower of FMV or loan outstanding (usually FMV)

Sales involving nonrecourse debt (box 5 on the Form 1099-A or Form 1099-C) do not have any CODI involved. In this case, only the sale needs to be reported. In sales involving recourse debt, CODI is usually equal to the amount of the outstanding debt less the property's FMV.

Taxpayers may receive both Forms 1099-A and 1099-C.

☐ CORRECTED (if checked)

LENDER'S name, street address, city, state, ZIP code, and telephone no.		OMB No. 1545-0877 2010 Form 1099-A	Acquisition or Abandonment of Secured Property
LENDER'S federal identification number / BORROWER'S identification number	1 Date of lender's acquisition or knowledge of abandonment	2 Balance of principal outstanding $	Copy B For Borrower
BORROWER'S name	3	4 Fair market value of property $	This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if taxable income results from this transaction and the IRS determines that it has not been reported.
Street address (including apt. no.)	5 Was borrower personally liable for repayment of the debt? ☐ Yes ☐ No		
City, state, and ZIP code	6 Description of property		
Account number (see instructions)			

Form **1099-A** (keep for your records) Department of the Treasury - Internal Revenue Service

☐ CORRECTED (if checked)

CREDITOR'S name, street address, city, state, ZIP code, and telephone no.	1 Date canceled 2 Amount of debt canceled $ 3 Interest if included in box 2 $	OMB No. 1545-1424 2010 Form 1099-C	Cancellation of Debt
CREDITOR'S federal identification number / DEBTOR'S identification number	4 Debt description		Copy B For Debtor
DEBTOR'S name			This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if taxable income results from this transaction and the IRS determines that it has not been reported.
Street address (including apt. no.)	5 Was borrower personally liable for repayment of the debt?		
City, state, and ZIP code	☐ Yes ☐ No		
Account number (see instructions)	6 Bankruptcy (if checked) ☐	7 Fair market value of property $	

Form **1099-C** (keep for your records) Department of the Treasury - Internal Revenue Service

Both of these information forms require taxpayers to report the amount on their tax returns. Failure to report CODI may prompt the IRS to issue a CP 2000 notice.

Taxpayers receive Form 1099-A when they are not personally liable for the loan and there is no CODI to report. In this situation, the taxpayer only has a sale transaction to report. Box 5 of Form 1099-A is checked "no."

It is possible that the lender will pursue the borrower for any remaining liability. The lender might issue a Form 1099-C at the conclusion of its failed attempts to collect in full. (Box 5 is checked "yes"). When box 5 on a Form 1099-A is checked "yes," it indicates that either collection will occur or forgiveness of indebtedness will follow and be reported on Form 1099-C. It is not necessary for a lender to issue Form 1099-A and Form 1099-C in the same tax year. The lender in these cases is only required to issue a 1099-C.

Example 4. Shawna has an outstanding $240,000 nonrecourse mortgage. She originally paid $225,000 for the residence and refinanced the mortgage several times. Housing values declined substantially in her area and she decided to abandon the mortgage when the FMV of her home dropped to $175,000. Shawna's gain or loss on the residence is calculated as follows:

Mortgage balance	$240,000
Basis of principal residence	(225,000)
Gain realized	$ 15,000
Gain excluded under §121 if ownership and residency tests are met	$ 15,000

Example 5. Use the same facts as **Example 4**, except the mortgage is a recourse mortgage. Shawna's gain or loss on the residence is calculated as follows:

FMV at time of foreclosure (deemed sale price)	$175,000
Basis of principal residence	(225,000)
Loss realized	($ 50,000)
Loss recognized (personal loss)	0
Mortgage balance (Box 2 of Form 1099-C)	$240,000
FMV at time of foreclosure (sale price) (Box 7 of Form 1099-C)	(175,000)
Cancellation-of-debt income (CODI)	$ 65,000

QUALIFIED PRINCIPAL RESIDENCE DEBT

A taxpayer can exclude CODI from income for tax years 2007 through 2012 if it relates to any mortgage incurred to buy, build, or improve the taxpayer's principal residence, and the mortgage is secured by the taxpayer's principal residence. Refinanced mortgage debt can also qualify, but only up to the amount of the old mortgage just prior to refinancing. The exclusion can also apply to a loan modification or reduction when the mortgage meets the aforementioned criteria. The exclusion does not apply to secondary homes, vacation homes, rental property, investment property, or business property. The exclusion amount is $2 million ($1 million MFS). Second mortgages or home-equity loans also qualify for this exclusion, provided the proceeds were used to buy, build or improve the taxpayer's principal residence and are secured by the principal residence.

Example 6. Bob's principal residence is secured by a $500,000 recourse mortgage and $400,000 of the mortgage is qualified principal residence indebtedness based on the purchase cost of the home. Bob refinanced his home and obtained an additional $100,000 to use for purposes other than improving the home.

The value of the home subsequently declined to $350,000 and Bob's lender foreclosed on the home.

Because the debt is recourse, Bob reports a sale of the lower of FMV or outstanding debt. Bob reports the following on his tax return:

Smaller of FMV or outstanding debt (deemed sale price)	$350,000
Basis of principal residence	(400,000)
Loss realized	($ 50,000)
Loss recognized (personal loss)	0
Mortgage balance	$500,000
FMV at time of foreclosure (sale price)	(350,000)
CODI	$150,000
Nonqualified debt	(100,000)
Excludable debt	$ 50,000

The remaining $100,000 is taxable unless it is excludable under another provision, such as insolvency.

Insolvency

Debt cancelled in Title 11 **bankruptcy** cases is excludable from income if the debtor is under the jurisdiction of a court and the debt is cancelled by the court.

The debt is not includible to the extent the taxpayer is **insolvent** immediately before the cancellation. The debtor's total liabilities must be in excess of the FMV of all assets including those beyond reach of creditors, such as retirement accounts.

A taxpayer cannot use the qualified principal residence indebtedness exclusion if the exclusion is due to Title 11 bankruptcy. If the exclusion is due to qualified principal residence indebtedness, the taxpayer can elect to exclude the CODI under the insolvency rules if this is more beneficial to the taxpayer.

A worksheet to compute insolvency is provided in IRS Pub. 4681, *Canceled Debts, Foreclosures, Repossessions, and Abandonments.*

Insolvency Worksheet

Keep for Your Records

Date debt was canceled (mm/dd/yy)		
Part I. Total liabilities immediately before the cancellation (do not include the same liability in more than one category)		
	Liabilities (debts)	**Amount Owed Immediately Before the Cancellation**
1.	Credit card debt	$
2.	Mortgage(s) on real property (including first and second mortgages and home equity loans) (mortgage(s) can be on personal residence, any additional residence, or property held for investment or used in a trade or business)	$
3.	Car and other vehicle loans	$
4.	Medical bills owed	$
5.	Student loans	$
6.	Accrued or past-due mortgage interest	$
7.	Accrued or past-due real estate taxes	$
8.	Accrued or past-due utilities (water, gas, electric)	$
9.	Accrued or past-due child care costs	$
10.	Federal or state income taxes remaining due (for prior tax years)	$
11.	Judgments	$
12.	Business debts (including those owed as a sole proprietor or partner)	$
13.	Margin debt on stocks and other debt to purchase or secured by investment assets other than real property	$
14.	Other liabilities (debts) not included above	$
15.	**Total liabilities immediately before the cancellation. Add lines 1 through 14.**	$
Part II. Fair market value (FMV) of assets owned immediately before the cancellation (do not include the FMV of the same asset in more than one category)		
	Assets	**FMV Immediately Before the Cancellation**
16.	Cash and bank account balances	$
17.	Homes (including the value of land) (can be main home, any additional home, or property held for investment or used in a trade or business)	$
18.	Cars and other vehicles	$
19.	Computers	$
20.	Household goods and furnishings (for example, appliances, electronics, furniture, etc.)	$
21.	Tools	$
22.	Jewelry	$
23.	Clothing	$
24.	Books	$
25.	Stocks and bonds	$
26.	Investments in coins, stamps, paintings, or other collectibles	$
27.	Firearms, sports, photographic, and other hobby equipment	$
28.	Interest in retirement accounts (IRA accounts, 401(k) accounts, and other retirement accounts)	$
29.	Interest in a pension plan	$
30.	Interest in education accounts	$
31.	Cash value of life insurance	$
32.	Security deposits with landlords, utilities, and others	$
33.	Interests in partnerships	$
34.	Value of investment in a business	$
35.	Other investments (for example, annuity contracts, guaranteed investment contracts, mutual funds, commodity accounts, interests in hedge funds, and options)	$
36.	Other assets not included above	$
37.	**FMV of total assets immediately before the cancellation. Add lines 16 through 36.**	$
Part III. Insolvency		
38.	**Amount of Insolvency.** Subtract line 37 from line 15. If zero or less, you are not insolvent.	**$**

Reduction of Tax Attributes

Taxpayers who have CODI but are claiming an exclusion from taxable income must file Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment),* and indicate on the form the amount of exclusion they are claiming and why. Homeowners must also reduce certain tax attributes such as the basis of their residence, if the residence is retained. This most commonly occurs when the lender makes a home-mortgage modification.

SALE OF PRINCIPAL RESIDENCE

In recent years, many modifications have occurred to the IRC §121 exclusion rules. More taxpayers are changing residential real property from primary residence status to business use and vice versa. As a result of these changes, reporting the sale of the property can be complicated.

Whether property is used by a taxpayer as a principal residence depends upon facts and circumstances. Principal residences may include a houseboat, house trailer, or house or apartment that the taxpayer is entitled to occupy as a tenant-stockholder in a cooperative housing corporation. Property used by the taxpayer as a principal residence does not include personal property that is not a fixture under local law.

If the taxpayer uses multiple properties as residences, then whether a property is used by the taxpayer as a principal residence depends on facts and circumstances. If the taxpayer alternates between residences, using them for successive periods of time, the property that the taxpayer uses a majority of time during the year ordinarily is considered the principal residence. Factors used to determine a taxpayer's principal residence include but are not limited to:

- Place of employment;
- Principal place of abode for family members;
- Addresses used on tax returns, driver's license, auto registration, and voter registration;
- Mailing address for bills and correspondence;
- Location of bank accounts; and
- Location of religious organizations and recreational clubs with which the taxpayer is affiliated.

The basis of the property is important both for determining gain or loss on its disposition and for depreciation purposes.

The basis of property is increased by:

1. The seller's real estate taxes (paid by buyer) owed on property purchased by buyer;
2. Any settlement costs and fees for acquiring the property such as:
    a. Abstract fees,
    b. Legal fees,
    c. Recording fees,
    d. Surveys,
    e. Transfer taxes,
    f. Title insurance, and
    g. Seller's expenses that the buyer agrees to pay;
3. Any assumptions of seller's debt;
4. Capital improvements made after the purchase; and
5. Assessments for local improvements such as sewer and water, sidewalks, and roads.

The basis of property is decreased by:

1. Energy credits;
2. The first-time homebuyer credit;
3. Depreciation;
4. The discharge of qualified principal residence indebtedness that was excluded from income;
5. Deductible casualty losses;
6. Insurance payment recoveries;
7. Payments for easements or grants of right of way; and
8. General sales taxes claimed as an itemized deduction on the purchase of personal property, such as a houseboat or mobile home used as a residence.

EXCLUSION OF GAIN ON SALE OF PRINCIPAL RESIDENCE

Under §121, single individuals can exclude up to $250,000 of gain if **both** of the following apply:

- The taxpayer owned and used the home as a principal residence for at least two years during the 5-year period ending on the date of sale. The time of usage does not need to be continuous, nor does it have to occur at the same time as ownership.
- During the 2-year period ending on the date of sale, the taxpayer did not exclude a gain on the sale of another home.

The ownership and use tests need not be concurrent. However, these requirements must be met within the 5-year period ending on the date of sale and can be met with nonconcurrent periods for a full 24 months, or 730 days.

Property acquired in a like-kind exchange in which gain is not recognized under IRC §1031 has a 5-year ownership period requirement rather than a 2-year ownership period.

Married individuals filing jointly (MFJ) can exclude up to $500,000 of gain, provided:

- One spouse meets the ownership test and both spouses meet the use test, and
- Neither spouse claimed a §121 exclusion within the prior two years.

If the above requirements are not satisfied, the maximum exclusion that can be claimed is the total for which each spouse would qualify if not married and the amounts were computed separately.

Special provisions relating to divorce allow the nonoccupant spouse who owns a home to meet the use test if the occupant spouse or former spouse is allowed to use the home under a divorce decree or separation instrument and uses the home as a principal residence. For property transferred from a spouse or former spouse incident to a divorce, the ownership of the transferee includes the period of ownership of the transferor spouse.

The $500,000 exclusion can apply to an unmarried surviving spouse if the house is sold within two years of the death of the spouse, provided:

- Either spouse meets the ownership requirement,
- Both meet the usage requirement, and
- The surviving spouse has not remarried.

Reduced Exclusion Provision

Taxpayers that fail to qualify for the full §121 exclusion may qualify for a reduced exclusion under Treas. Reg. §1.121-3. Reduced exclusions apply if the taxpayer sold or exchanged the residence due to a change in place of employment, health, or unforeseen circumstances. If a safe harbor is met as described in the regulations, then the sale is deemed to be for one of these three reasons. If a safe harbor does not apply, then all relevant facts are examined to determine the primary reason for the sale or exchange. Factors that may be relevant include the following:

- The sale and circumstances causing the sale are proximate in time.
- The suitability of the home as a principal residence materially changes.
- The taxpayer's financial ability to maintain the home becomes materially impaired.
- During the time the taxpayer owned the property, he used it as his principal residence.
- The circumstances giving rise to the sale or exchange were not reasonably foreseeable when the taxpayer began using the property as the taxpayer's principal residence.
- The circumstances causing the sale occurred during the time the taxpayer owned and used the property as his principal residence.

The **change-in-place-of-employment exception**[10] is available if an employment change is the primary reason for the sale. However, there is a safe-harbor **distance requirement**. The new place of employment must be at least 50 miles further from the residence sold than the former place of employment. If there is no former place of employment, the distance between the qualified new place of employment and the sold residence must be at least 50 miles.

> **Example 7.** Alvin is unemployed and owns a townhouse. He owned and used this townhouse as his principal residence since 2008. In 2009, Alvin obtains a job that is 54 miles from his townhouse, and he sells the townhouse. Because the distance between his new place of employment and the townhouse is at least 50 miles, the sale is eligible for the §121 exclusion. Alvin can obtain a reduced maximum exclusion.

> **Example 8.** Candice is an emergency room physician. In July 2008, she purchases a condominium that is five miles from her place of employment and uses it as her principal residence. In February 2009, Candice obtains a job that is located 51 miles from her condominium. Candice may be called in to work unscheduled hours, and when called, must be able to arrive at work quickly. Because of the demands of the new job, Candice sells the condominium and buys a townhouse that is four miles from her new job. Because Candice's new job is only 46 miles farther than her previous job, the sale is not within the 50-mile safe harbor. However, Candice is entitled to a **reduced** §121 exclusion because the reason for the sale is a change in employment.

The **health exception**[11] applies if the primary reason for selling is to obtain, provide, or facilitate the diagnosis, cure, mitigation, or treatment of a disease, illness, or injury of a qualified individual. A qualified individual for the health safe harbor is the taxpayer, spouse, co-owner, another person whose principal place of abode is in the same household as the taxpayer, or a person bearing any of the following relationships even though the taxpayer is not living with this person at the time of sale:

- Parent, grandparent, stepmother, or stepfather
- Child, grandchild, stepchild, or adopted child
- Brother, sister, stepbrother, stepsister, half brother, or half sister
- Mother-in-law, father-in-law, brother-in-law, sister-in-law, son- or daughter-in-law
- Uncle, aunt, nephew, or niece

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10. Treas. Reg. §1.121-3(c)(1).

11. Treas. Reg. §1.121-3(d)(1).

The **unforeseen-circumstances exception**[12] is available when the primary reason for selling is the occurrence of an event that the taxpayer could not reasonably anticipate before purchasing and occupying the residence. Safe harbors for unforeseen circumstances include:

- Involuntary conversion,
- Natural or man-made disasters,
- Death,
- Cessation of employment and the individual is eligible for unemployment,
- Divorce or legal separation,
- Multiple births, and
- Other situations published by the IRS or rulings addressed to specific individuals.

Example 9. In December 2009, on the advice of their doctor, Liz and Charles sell their Iowa home and move to a condo they purchased on the Gulf Coast. Due to a chronic condition, Charles is required to spend at least one hour per day in salt water. Due to oil-polluted waters, Liz and Charles are forced to sell their condo in June 2010 and move to the east coast of Florida. They meet the unforeseen-circumstances exception.

Reduced Exclusion Calculation

Taxpayers qualifying for a reduced maximum exclusion multiply the maximum exclusion (either $250,000 or $500,000) by a fraction. The numerator is the shortest of the following time periods:

- The time period[13] the taxpayer owned the property during the 5-year period ending on the date of sale
- The time period the taxpayer used the property as a principal residence during the 5-year period ending on the date of sale
- The time period between the date of a prior sale or exchange of property for which the taxpayer excluded the gain under §121 and the date of the current sale or exchange

The denominator is 730 days or 24 months depending on whether the period used in the numerator is days or months.

Example 10. Harry owns a house that he used as his principal residence since 1994. On January 15, 2009, Harry marries Sally and Sally begins using Harry's house as her principal residence. On January 15, 2010, Harry sells the house because of a change in Sally's employment. Neither Harry nor Sally utilized the §121 exclusion in the last two years. Because Sally does not meet the ownership-use test, the maximum exclusion is figured for both Harry and Sally as if they had not been married. Harry is eligible to exclude up to $250,000 because he meets both requirements of §121. Sally is not eligible for the maximum exclusion. Instead, because of a change in employment, she is eligible for a $125,000 exclusion ((365 ÷ 730) × $250,000). Therefore, Harry and Sally are eligible to exclude up to $375,000 ($250,000 + $125,000) of gain from the sale of their home.

12. Treas. Reg. §1.121-3(e)(1).

13. Treas. Reg. §1.121-3(g)(1). The time period may be expressed in either days or months.

Special Rule for Taxpayers Incapable of Self-Care

Taxpayers who become physically or mentally incapable of self-care and currently reside in any facility licensed by a state or political subdivision to care for an individual in the taxpayer's condition can qualify for the §121 exclusion. The taxpayer must have used the former residence as a principal residence for an aggregate period of one year. The taxpayer is treated as using the property as a principal residence for any period of time he resides in a qualifying facility during the 5-year period preceding the sale or exchange.[14]

Election to Not Use Exclusion

A taxpayer can elect to not apply the exclusion of gain under §121 by reporting the sale on Schedule D. This choice can be made or revoked at any time before the expiration of a 3-year period beginning on the due date of the taxpayer's return, not including extensions. A taxpayer may want to consider this alternative when he sells multiple properties that qualify for the §121 exclusion. However, he is still subject to the two-out-of-five-year rule.

SALE OF VACANT LAND

The sale of vacant land[15] is not a sale or exchange of a principal residence unless:

- The vacant land is adjacent to land containing the principal residence,
- The taxpayer owned and used the vacant land as part of the principal residence,
- The taxpayer sells or exchanges the principal residence meeting the §121 exclusion requirements within two years before or after the sale of the land, and
- The ownership and use test requirements of §121 have been met for the vacant land.

The maximum exclusion of $250,000 or $500,000 applies to the combined sales of the principal residence and the vacant land. If the gain on the combined sales exceeds the maximum combined exclusion, then the gain on the dwelling unit is excluded first. The sale of the vacant land and dwelling unit comprise one sale for purposes of the one-exclusion-every-two-year rule.

If the sale of the vacant land occurs before the sale of the principal residence, the sale must be treated as taxable on the taxpayer's return for the year of sale of the vacant land. If the sale of land subsequently qualifies for a §121 exclusion based on the sale of the principal residence within two years, the taxpayer may claim a §121 exclusion on the sale of land by filing an amended return.

Example 11. Lori purchases property consisting of a dwelling and 10 acres in 2000. She uses this property as her principal residence. In May 2009, Lori sells eight acres of land and realizes $110,000 of gain. Lori does not sell the dwelling before the due date for filing her 2009 return. Therefore, she must report the $110,000 as gain on her tax return.

In June 2010, Lori sells the house and remaining two acres and realizes a gain of $180,000. Lori may exclude the $180,000 gain under §121 on her 2010 return. Because the sale of the eight acres occurred within two years of the date of sale of Lori's principal residence, she may file an amended 2009 return and claim a $70,000 ($250,000 – $180,000) §121 exclusion.

Example 12. In 1998, Darren buys a house and one acre that he uses as his principal residence. In 1999, he purchases an additional 29 acres adjacent to his house and uses the additional land as part of his principal residence. In 2010, he sells the house and one acre and realizes a loss of $25,000. Later that same year, Darren realizes $270,000 of gain from the sale of the 29 acres. He may exclude the $245,000 ($270,000 – $25,000) net gain from the two sales.

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14. Treas. Reg. §1.121-1(c)(2).

15. Treas. Reg. §1.121-1(b)(3).

BUSINESS USE OR RENTAL OF HOME

A taxpayer may be able to exclude gain from the sale of a home that has been used for business or rental activities if he meets the ownership and use tests. Gain attributable to depreciation claimed after May 6, 1997, is not eligible for the §121 exclusion. The ability to exclude gain on the sale of a residence used for business or rental purposes depends on whether the portion of the property used for nonresidential purposes is within the same dwelling unit. If the nonresidential portion is not within the same dwelling unit as the residential portion, the taxpayer must prorate the sale and gain or loss of the residence as separate sales of business or rental property and residence.[16]

Nonqualified Use

For sales and exchanges after December 31, 2008, the Housing Assistance Tax Act of 2008 reduced the exclusion of eligible gain under §121 to the extent gain is allocated to nonqualified usage. Starting in 2009, a portion of the gain on a principal residence may be taxable if it was used other than as a principal residence. This prevents taxpayers from selling a second home, vacation home, or rental home and excluding all of the gain even if they meet the §121 two-out-of-five-year use and ownership requirements.

Nonqualified usage is any period of time after December 31, 2008, that the property is not used as the principal residence of the taxpayer, spouse, or former spouse. If the property is used as a principal residence after December 31, 2008, there is no nonqualified usage if the taxpayer **subsequently** uses the property for a nonqualified purpose. Consequently, the home may be eligible for the full §121 exclusion, provided the two-out-of-five-year test is met.

The gain allocated to nonqualified use is determined by the following calculation:

$$\textbf{Gain Allocated to Nonqualified Use} = \textbf{Total Gain} \times \frac{\textbf{Aggregate Periods of Nonqualified Use}}{\textbf{Total Period of Time Taxpayer Owned Property}}$$

Recapture of depreciation is applied before the gain allocated to periods of nonqualified use. The gain allocated to nonqualified use is based on the total gain less any gain recognized due to post-May 6, 1997 depreciation.

Example 13. Robin purchases a secondary residence on March 1, 2004, for $200,000. On June 1, 2007, Robin converts the residence to rental property and continues to rent it until September 1, 2011, at which time he converts the property to his principal residence. On September 1, 2013, Robin reconverts the property back to rental property and finally sells it on November 1, 2014, for $300,000. Robin claimed $36,000 of depreciation during the time it was held for rent.

Robin's gain is shown below.

Sales price	$300,000
Less: purchase price	(200,000)
Plus: depreciation allowed	36,000
Total gain	$136,000
Unrecaptured §1250 gain	(36,000)
Remaining gain to be allocated	$100,000
Taxable gain due to nonqualified use (32/128 × $100,000) [a] treated as long-term capital gain	(25,000)
Remaining gain excluded under §121	$ 75,000

[a] Period of nonqualified use (Jan. 1, 2009 through Aug. 31, 2011) = 32 months
Total time property owned (Mar. 1, 2004 through Nov. 1, 2014) = 128 months

Note. In **Example 13,** any portion of use as a secondary residence after December 31, 2008, would be included in the nonqualified use. See pages 430–432 in the 2008 *University of Illinois Federal Tax Workbook* for a thorough discussion of the nonqualified use rules. This can be found on the accompanying CD.

16. Treas. Reg. §1.121-1(e)(1).

RENTAL OF VACATION HOMES

In recent years, many taxpayers acquired second homes as an investment during the real estate boom. Because of depressed real estate prices, many taxpayers put these properties up for rent rather than selling them. It is important for tax professionals to properly classify these rentals and advise clients regarding how to best manage and evaluate these assets.

Vacation homes are dwelling units that may be used by a taxpayer for both personal purposes and as rental units. If a taxpayer has no personal usage and only rents the property or holds it out for rental, it is treated strictly as rental property and reported on Schedule E, *Supplemental Income and Loss.* Special tax rules apply to property used for both rental and personal purposes (vacation homes).

A home or dwelling unit includes a house, apartment, condominium, mobile home, motor home, yacht, boat, or recreational vehicle.[17] To be considered a home, the property must have a sleeping place, toilet facilities, and cooking facilities.

When there is both personal and rental use, the property can be considered one of the following based on the amount of personal use and rental use. The following tax consequences apply:

- **Personal Use Property.** When **personal use property** is rented less than 15 days and the taxpayer uses it more than 14 days, the **rental income is not taxable.**[18] Real estate taxes and mortgage interest are reported on Schedule A, provided mortgage interest rule limitations (discussed earlier) are met. Other expenses related to the property are generally nondeductible.
- **Rental Property.** When **rental property** is utilized for personal use no more than 14 days or 10% of the days the property is rented, the rental activity is reported on Schedule E with expenses allocated to rental and personal use.[19] Only real estate taxes are deductible as both personal and rental expenses. The personal portion is deducted on Schedule A. **The personal portion of mortgage interest is not deductible on Schedule A,** because the property is not considered used as the taxpayer's home, but it may be deductible on Schedule A as investment interest. Rental activity is subject to passive-activity loss limits.
- **Hobby Rental Property.** When the personal-use test for rental property is not met and the home is rented for more than 14 days, rental activity is reported on Schedule E with expenses allocated to rental and personal use. **Rental expenses are limited to gross rental income.**[20] The personal use portions of real estate taxes and mortgage interest are deductible on Schedule A. The taxpayer is deemed to have used the property as a home or residence. Mortgage interest is deductible if the taxpayer elects to treat this property as a second home under mortgage interest rules.

PERSONAL USE

Days that constitute personal use are important for proper classification and treatment of rental activity.[21] The following are deemed personal use:

- Usage by the taxpayer or anyone who owns an interest in the property unless it is rented under a shared equity financing agreement[22]
- Usage by family members of any owners in the property unless the family members use it as their principal residence and pay a fair rental price. Family members include spouse, brothers and sisters, half-brothers and half-sisters, ancestors, and lineal descendants[23]

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17. IRC §280A(f)(1)(A).
18. IRC §280A(g)(2).
19. IRC §280A(d)(1).
20. IRC §280A(c)(5).
21. IRS Pub. 527, *Residential Rental Property* (Dec. 2, 2009).
22. IRC §280A(d)(3)(B)(i).
23. IRC §280A(d)(3)(A).

- Rentals at less than fair market value
- Swaps under exchange agreements
- Charitable donation use of the property whereby the purchaser at a charity event pays the charity for the use of the property

The days that the taxpayer works full time repairing and maintaining the property are not counted as personal use even if family members use the property for recreational purposes on the same day. The IRS has taken the position that improving the property does not constitute repair and maintenance, although the tax court ruled against the IRS in the *Twohey* case.[24]

There is an exception for personal-use days in determining whether the dwelling unit is used as rental property or as a hobby rental. The taxpayer does not have to count as personal days the period when the home is used as a main home before or after renting it or offering it for rent. The days that the property is used as a main residence are not counted as personal days when the taxpayer rented or tried to rent the property for 12 or more consecutive months or when the period is less because the property was sold or exchanged.

> **Note.** The special rule does not apply to allocation of personal and rental days in allocation of expenses. It is only used in determining whether the property is rental property or a hobby rental.

ALLOCATING RENTAL EXPENSES

To allocate expenses to rental activities on Schedule E, the taxpayer must know the number of days the property is actually rented and the number of personal use days. In Prop. Treas. Reg. §1.280A-3, the IRS computes allocation of expenses to the rental activity based on the following fraction:

$$\text{Rental Expenses} = \left(\frac{\text{Days Rented}}{\text{Days Occupied or Rental Days} + \text{Personal Use Days}}\right) \times \text{Property Expenses}$$

If the taxpayer has rental property rather than a hobby rental, this method allocates more expenses to the rental activity and less to Schedule A. The taxpayer is not allowed a mortgage-interest deduction for the nonrental portion because the property is not deemed to be a residence.

If, however, the taxpayer has a hobby rental and possible limitation of deductions to the extent of rental income, the taxpayer may want to apply the *Bolton*[25] method of allocating expenses. This increases deductions on the Schedule A and lowers deductions on the Schedule E. *Bolton* applies the following formulas:

$$\text{Rental Tax and Interest Expense} = \frac{\text{Days Rented}}{\text{Total Days in Year}} \times \text{Total Property Taxes and Mortgage Interest}$$

$$\text{Rental Maintenance Expense} = \frac{\text{Days Rented}}{\text{Days Occupied}} \times \text{Total Maintenance Expense}$$

$$\text{Rental Depreciation Expense} = \frac{\text{Days Rented}}{\text{Days Occupied}} \times \text{Total Depreciation Expense}$$

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24. *Twohey v. Comm'r,* TC Memo 1993-547 (Nov. 22, 1993).

25. *Bolton v. Comm'r,* 82-2 USTC ¶9699; No. 82-7013, 694 F.2d 556 (9th Cir. 1982), *aff'g* 77 TC 104.

Example 14. The following example illustrates both the proposed regulations and the *Bolton* case.

Personal use	21 days
Rented at FMV	90 days
Vacant	254 days
Rental income	$16,000

Expenses incurred on the property for the year were:

Real estate taxes	$ 4,000
Mortgage interest	10,000
Maintenance and utilities	5,000
Depreciation	9,000

Under Prop. Treas. Reg. §1.280A-3, the IRS would allocate 81% (90 ÷ 111) of the interest and taxes to Schedule E and 19% (21 ÷ 111) to the Schedule A.

Under the *Bolton* case, interest and taxes would be allocated 25% (90 ÷ 365) to the Schedule E and 75% to the Schedule A.

Expenses would be allocated to the Schedule E as follows:

	Prop. Reg.		Bolton	
Rental income	$16,000		$16,000	
Real estate taxes	3,240	(81% × $4,000)	1,000	(25% × $4,000)
Mortgage interest	8,100	(81% × $10,000)	2,500	(25% × $10,000)
Maintenance and utilities	4,050	(81% × $5,000)	4,050	
Depreciation	610 [a]	(81% × $9,000)	7,290	
Net rental income	$ 0		$ 1,160	

[a] The rental expense under the IRS position in the proposed Treasury regulation is limited due to rental income; thus, there is a carryover of the excess depreciation.

Expenses would be allocated to Schedule A as follows:

	Prop. Reg.		Bolton	
Real estate taxes	$ 760	(19% × $4,000)	$ 3,000	(75% × $4,000)
Mortgage interest	1,900	(19% × $10,000)	7,500	(75% × $10,000)
	$2,660		$10,500	

The *Bolton* method may be more favorable because there are additional itemized deductions of $7,840 ($10,500 – $2,660) to offset the income of $1,160. However, if the taxpayer is subject to AMT and has a home mortgage interest deduction limitation on Schedule A, *Bolton* might not be more favorable.

PASSIVE ACTIVITY LOSS CONSIDERATIONS

Real property rental is generally deemed a passive activity unless the taxpayer is a real estate professional. It is possible for taxpayers to deduct up to $25,000 of rental losses from rental of vacation homes, provided the property is rental property and not a hobby rental. The taxpayer must have at least a 10% ownership in the property and **actively participate** in the management of the property. This is a lower standard than that of material participation.

Active participation means making management decisions and/or arranging for others to provide services, such as repairs. Approving new tenants, deciding on rental terms, and approving capital or repair expenditures constitutes active participation.

$25,000 RENTAL LOSS SPECIAL ALLOCATION

Taxpayers who actively participate in a passive rental real estate activity can deduct up to $25,000 (MFJ) or $12,500 (MFS) of rental losses. Form 8582, *Passive Activity Loss Limitations*, provides for this special allowance. The loss allowance is reduced based on a taxpayer's MAGI. It is subject to a 50% reduction in the otherwise allowable deduction for MAGI amounts between $100,000 and $150,000. The phaseout range is from $50,000 to $75,000 for MFS taxpayers. The MAGI limitation is the taxpayer's AGI without taking into account the following:

- Deductions for IRAs and other qualified retirement plans
- Taxable social security and tier 1 railroad retirement benefits
- The deduction for half of the self-employment (SE) tax
- Interest on student loans
- The IRC §199 domestic production activities deduction
- Tuition deduction
- Passive income or loss from Form 8582
- Rental real estate losses allowed to real estate professionals
- Income excluded from employer adoption assistance program
- The interest-income exclusion for U.S. savings bonds used for qualified higher education

CARRYOVER OF EXPENSES AND LOSSES

Rental Property

Taxpayers who either do not actively participate, generate losses in excess of $25,000, or are subject to MAGI limitations usually have passive loss carryforwards. These losses are subject to passive activity limitations under IRC §469 and are reported on Form 8582. Carryforward losses can be freed up by subsequent active participation in the rental activity, the $25,000 limitation, or other passive income, provided they do not exceed the MAGI limitations. When the property is disposed of in a taxable transaction, all carryforward losses are freed up and are not subject to the limitations.

Hobby Rental

Hobby rentals (vacation homes) by definition are specifically exempted from passive loss rules, and expenses are limited to income from the activity. Losses are not allowed, and excess expenses may be carried forward. Expenses carried forward may only be used against future income from this rental. Rental expenses are applied up to the amount of rental income in the following order:

1. Mortgage interest
2. Taxes
3. Direct rental expenses
4. Operating expenses
5. Depreciation

Expenses carried forward are lost if the property is sold. Depreciation carried forward is added back to the property's basis when it is sold or exchanged because it was never allowed or allowable.

> **Note.** For further discussion of rental real estate, see Problem 5, Rental Real Estate Problems, in Chapter 5, Individual Taxpayer Problems.

BUSINESS USE OF HOME

It is easier for taxpayers to qualify for the business use of the home deduction since the passage of the Tax Reform Act of 1997. It is also less detrimental to many taxpayers who claim the deduction and subsequently sell their homes than it was previous to the §121 exclusion.

WHO IS ELIGIBLE?

Sole proprietors (Schedule C), farmers (Schedule F), employees (Form 2106 and Schedule A), and partners (Schedule E) are eligible for the deduction. The deduction can be the most beneficial when it reduces the SE income of the taxpayer.

To claim a deduction for business use of the home, taxpayers must use a portion of their home **regularly** and **exclusively** for a **trade or business activity.** The home office must also be **one** of the following:

- The taxpayer's principal place of business[26]
- A place where the taxpayer meets with patients, clients, or customers in the normal course of business
- Located in a separate structure that is not attached to the dwelling unit

Employees have additional tests. The business use of the home must be for the convenience of the employer, and the employee must not rent any part of the home to his employer and use the rented portion to perform services as an employee for that employer.[27] Employees who have offices at work but choose to work at home are disallowed the deduction because it does not meet the "for the convenience of the employer" requirement.

A home office is deemed for the convenience of the employer if it is:

- Required as a condition of employment,
- Necessary for the employer's business to function, and
- Necessary for the employee to perform his duties.

Partners may deduct business use of home expenses if they are required to pay them under a written partnership agreement. If they could have been reimbursed but did not seek reimbursement from the partnership, they cannot take the deduction.

If the taxpayer is a shareholder in an S corporation and he uses his residence for business, the shareholder-employee cannot claim a home-office deduction on Schedule E. However, the shareholder-employee can:

- Take an unreimbursed employee business deduction on Schedule A, as computed on Form 2106, *Employee Business Expense;*
- Get reimbursed for direct expenses under an accountable plan; or
- Take a reasonable rent allowance which the corporation can deduct, but which the taxpayer must report on Schedule E as income with no offsetting deductions.

Regular use means using the space on a continuous, ongoing, and recurring basis. Even if the space is never used personally, regular use means more than occasional or incidental business use.

Exclusive use means no personal use even if the space is used solely for business during business hours. The area does not need to be an entire room and does not need to be marked off by a permanent partition. The area should not contain any personal-use items such as TVs or personal-use computers. Exceptions to the exclusive-use test are storage of inventory and product samples and daycare facilities.

26. IRC §280A(c)(1)(A).

27. Ibid.

The taxpayer meets the exception for the exclusive-use test for storage of inventory or product samples if all of the following tests are satisfied:[28]

- The taxpayer is in a trade or business of selling products at retail or wholesale
- The taxpayer's home is the only fixed location of the trade or business
- The storage space is a separate, identifiable space used on a regular basis

Daycare facilities do not have to meet the exclusive-use test if both of the following conditions are met:[29]

- The taxpayer is in the trade or business of providing daycare for children, for persons age 65 or older, or for persons physically or mentally unable to care for themselves.
- The taxpayer must have applied for, been granted, or be exempt from having a license under state law.

> **Note.** Unlicensed daycare homes which are not exempt from licensing are not eligible for business use of home deductions. These deductions can be substantial.

Deductions for business use of the home are not allowed for hobby-type activities that do not rise to the level of a trade or business. It is possible for activities to be classified one year as a trade or business and fall to a hobby level or vice versa the next year.

The location of the principal place of business is an issue if the taxpayer has more than one location from which he does business. Administrative and management activities qualify a residence for business use of the home if the space is used regularly and exclusively for administrative or management activities and the taxpayer has no other fixed location where he conducts substantial administrative or management activities.

Administrative and management activities performed at other locations do not necessarily disqualify the taxpayer's home office from being considered the principal place of business. The following examples do not disqualify a taxpayer from having a home office as a principal place of business:

- The taxpayer has other space outside his home to conduct administrative and management activities but chooses instead to use his home office.
- The taxpayer provides services, meets with clients, or sells goods at locations outside of the home office.
- Third parties or employees conduct administrative and management activities at locations outside the home.
- The taxpayer does administrative and/or management activities at **nonfixed locations,** such as in a hotel room.

If a taxpayer does not satisfy the administrative and management activity tests, then the relative importance of the activities performed at each location and the amount of time spent at each location are taken into consideration to determine which location, if any, qualifies as the principal place of business.

The place to meet clients test can qualify taxpayers for business use of the home even though the space is not the principal place of business. If the taxpayer regularly and exclusively uses the space to meet with clients, customers, or patients and the use of this space is substantial and integral to the conduct of the trade or business, he can qualify for business use of the home. It is important, however, in these situations that the space be used regularly and exclusively, not just occasionally or incidentally.

A separate structure not attached to the taxpayer's home, such as a garage, studio, or barn, can qualify for the deduction, provided it is used regularly and exclusively.

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28. IRC §280A(c)(2).

29. IRC §280A(c)(4).

EXPENSES

A potential indirect benefit to the taxpayer who is eligible for a home-office deduction is transportation expenses. Transportation costs between a taxpayer's home and work are usually nondeductible commuting expenses. However, taxpayers traveling between their home office and any other work locations in the same trade or business have deductible traveling expenses.[30] In these situations, it does not matter whether the work location is regular or temporary and/or in or outside the metropolitan area of the taxpayer's residence.

A mortgage interest deduction for business use of the home does not include mortgage interest that did not benefit the home, such as home equity loan proceeds used to pay credit card balances or for the purchase of an automobile.

IRC §262(b) disallows a business use of the home deduction for basic local telephone service for the first telephone line into a taxpayer's residence, as it is deemed to be a personal expense.

DEDUCTION LIMITATION

The business use of home deduction is limited to the gross income from the business activity conducted in the home minus total business expenses. Gross income includes any gains on the sale of business assets included on Form 4797, *Sale of Business Property*. Business expenses include any expenses that would be deductible even if the taxpayer did not qualify for business use of the home, such as mortgage interest and real estate taxes that would otherwise be allowable on Schedule A.

The business use of home deduction is allowable to the extent of gross income minus total business expenses in the following order:

1. Mortgage interest, property taxes, and casualty losses allowable in full even if they exceed gross business income
2. All other business use of home deductions except depreciation (limited to gross business income)
3. Allowable depreciation (limited to gross business income minus all other business use of home deductions)

Allowable business use of home deductions and depreciation **cannot** create or increase a business loss to the taxpayer. Mortgage interest, property taxes, and casualty losses **can** create or increase a business loss even though they may be otherwise deductible. This could be significant, for example, in the case of taxpayers who have an NOL to carry back or carry forward since these expenses would increase the amount of the NOL.

Carryforwards

When the taxpayer has gross business income limitations, expenses related to both business use of the home and depreciation are denied in the current year. These expenses can be carried forward indefinitely. The carryforwards are applied to the next succeeding tax year in the order previously discussed. In many cases, the taxpayers derive two carryforward amounts (expenses for business use of the home and depreciation).

The amounts carried forward relate to the business and are tied to the gross income limitation and not the residence itself. Thus, if the taxpayer sells, exchanges, or stops using the residence, the carryforwards are not lost or immediately utilized. If, however, the taxpayer ceases operating the business, any carryforward deductions are lost. The basis of the taxpayer's residence is not reduced by any depreciation that was carried forward or never allowed.

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30. Rev. Rul. 99-7, IRB 1999-5.

REPORTING EXPENSES

Schedule C taxpayers are the only filers to use Form 8829, *Expenses for Business Use of Your Home,* in computing and filing their tax returns. Farmers file Schedule F and employees use Form 2106. Partners do not use Form 8829. Instead, they use worksheets to compute their business use of the home deductions.

Example 15. Terri edits manuscripts for graduate students. She has one room in her residence used solely for this purpose. Terri's Schedule C reports a net profit of $2,500 before claiming any home office deduction. There are no direct expenses related to the home office. Her indirect expenses include the following:

Mortgage interest	$8,000
Real estate taxes	2,000
Insurance	500
Utilities	3,000

The home office utilized 10% of the total home square footage. The home has an adjusted basis of $110,000, of which $20,000 is the basis of the lot.

Terri files the following Form 8829 with her income tax return.

For Example 15

Form **8829**

Department of the Treasury
Internal Revenue Service (99)

Expenses for Business Use of Your Home

▶ File only with Schedule C (Form 1040). Use a separate Form 8829 for each home you used for business during the year.

▶ See separate instructions.

OMB No. 1545-0074

2010

Attachment Sequence No. 66

Name(s) of proprietor(s)	Your social security number
TERRI	444-44-4444

Part I Part of Your Home Used for Business

1	Area used regularly and exclusively for business, regularly for daycare, or for storage of inventory or product samples (see instructions)			1	160
2	Total area of home			2	1,600
3	Divide line 1 by line 2. Enter the result as a percentage			3	10 %
	For daycare facilities not used exclusively for business, go to line 4. All others go to line 7.				
4	Multiply days used for daycare during year by hours used per day	4	hr.		
5	Total hours available for use during the year (365 days x 24 hours) (see instructions)	5	8,760 hr.		
6	Divide line 4 by line 5. Enter the result as a decimal amount	6	.		
7	Business percentage. For daycare facilities not used exclusively for business, multiply line 6 by line 3 (enter the result as a percentage). All others, enter the amount from line 3 ▶			7	10 %

Part II Figure Your Allowable Deduction

			(a) Direct expenses		(b) Indirect expenses		
8	Enter the amount from Schedule C, line 29, **plus** any net gain or (loss) derived from the business use of your home and shown on Schedule D or Form 4797. If more than one place of business, see instructions					8	2,500
	See instructions for columns (a) and (b) before completing lines 9–21.						
9	Casualty losses (see instructions)	9					
10	Deductible mortgage interest (see instructions)	10			8,000		
11	Real estate taxes (see instructions)	11			2,000		
12	Add lines 9, 10, and 11	12			10,000		
13	Multiply line 12, column (b) by line 7			13	1,000		
14	Add line 12, column (a) and line 13					14	1,000
15	Subtract line 14 from line 8. If zero or less, enter -0-					15	1,500
16	Excess mortgage interest (see instructions)	16					
17	Insurance	17			500		
18	Rent	18					
19	Repairs and maintenance	19					
20	Utilities	20			3,000		
21	Other expenses (see instructions)	21					
22	Add lines 16 through 21	22			3,500		
23	Multiply line 22, column (b) by line 7			23	350		
24	Carryover of operating expenses from 2009 Form 8829, line 42			24			
25	Add line 22 column (a), line 23, and line 24					25	350
26	Allowable operating expenses. Enter the **smaller** of line 15 or line 25					26	350
27	Limit on excess casualty losses and depreciation. Subtract line 26 from line 15					27	1,150
28	Excess casualty losses (see instructions)			28			
29	Depreciation of your home from line 41 below			29	221		
30	Carryover of excess casualty losses and depreciation from 2009 Form 8829, line 43			30			
31	Add lines 28 through 30					31	221
32	Allowable excess casualty losses and depreciation. Enter the **smaller** of line 27 or line 31					32	221
33	Add lines 14, 26, and 32					33	1,571
34	Casualty loss portion, if any, from lines 14 and 32. Carry amount to **Form 4684** (see instructions)					34	
35	**Allowable expenses for business use of your home.** Subtract line 34 from line 33. Enter here and on Schedule C, line 30. If your home was used for more than one business, see instructions ▶					35	1,571

Part III Depreciation of Your Home

36	Enter the **smaller** of your home's adjusted basis or its fair market value (see instructions)	36	110,000
37	Value of land included on line 36	37	20,000
38	Basis of building. Subtract line 37 from line 36	38	90,000
39	Business basis of building. Multiply line 38 by line 7	39	9,000
40	Depreciation percentage (see instructions)	40	2.461 %
41	Depreciation allowable (see instructions). Multiply line 39 by line 40. Enter here and on line 29 above	41	221

Part IV Carryover of Unallowed Expenses to 2011

42	Operating expenses. Subtract line 26 from line 25. If less than zero, enter -0-	42	
43	Excess casualty losses and depreciation. Subtract line 32 from line 31. If less than zero, enter -0-	43	

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 13232M Form **8829** (2010)

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Employees using Form 2106, which flows to Schedule A, are subject to the 2% of AGI limitation. They do not report their portion of mortgage interest and real estate taxes on Form 2106 or Schedule A (subject to 2%) but rather report them on the usual place on Schedule A. However, the deductions on Schedule A subject to the 2% of AGI limitation may be of limited use to the taxpayer because of AMT.

Partners claim their home-office deduction on Schedule E (page 2, Part II) on a separate line that is not combined with any other partnership amounts and is labeled as unreimbursed partnership expense. Partners are allowed to deduct the mortgage interest and real estate tax amounts regardless of gross business income, provided they meet basis and passive activity tests and thus they are similar to Schedule C taxpayers.

LIKE-KIND EXCHANGES OF TAXPAYER RESIDENCES

IRC §1031 provides that:

> *. . . no gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment.*

Taxpayers may find it economically advantageous to use like-kind exchange treatment for qualifying property that has appreciated in value or has been heavily depreciated. This postpones the income tax consequences of gains on sales of properties and/or reallocates assets invested or deployed in a trade or business. If properties have depreciated in value and the taxpayers have unrealized losses, they obviously might not want to employ like-kind exchange deferral methods.

TYPES OF EXCHANGES

Simultaneous Exchange. The exchange of relinquished property for the replacement property occurs at the same time. These can be two party or multi-party transactions.

Deferred Exchange. This type of exchange occurs when there is a gap of time between the transfer of relinquished property and the acquisition of replacement property. These exchanges are subject to strict time limits and require a qualified intermediary.

Reverse Exchange. This type of exchange occurs when replacement property is acquired prior to transferring the relinquished property. These exchanges require an exchange-accommodation titleholder.

LIKE-KIND REAL PROPERTY

Almost all real estate is like-kind to any other real estate, whether improved or not. Real property located outside the United States is not like-kind to property located within the United States.[31] If both pieces of property are located outside the United States, like-kind treatment can apply. Real property held for sale as inventory by a dealer does not qualify; however, unproductive real estate held as investment property by a nondealer does qualify.[32]

TRADE, BUSINESS, AND INVESTMENT USE

Whether property is held for use in a trade or business or for investment purposes is determined at the time the property is exchanged.[33] The taxpayer has the burden of proof as to the intent in acquiring property for a trade or business or for investment purposes. A minimal amount of personal use will not taint the issue of the property qualifying for like-kind exchange treatment. Taxpayers, however, who acquire or construct property solely for the purpose of exchanging it for other like-kind property may find that the IRS challenges whether the taxpayer did, in fact, hold the property for productive use in a trade or business or for investment. The intent of the taxpayer is very important in this determination.

31. IRC §1031(h)(1).

32. IRC §1031(a)(2)(A).

33. *Fred S. Wagensen v. Comm'r,* 74 TC 653 (July 9, 1980).

There are no specific holding periods for property relinquished or acquired to qualify for like-kind exchange treatment. When the property changes use after a like-kind exchange, the original intent becomes even more important for determination of eligibility. The only exception to a specific holding period is for a personal residence gain exclusion under §121 acquired in a like-kind exchange. The American Jobs Creation Act of 2004 revised §121 to require a 5-year holding period following an exchange and conversion of property to a principal residence before gain can be excluded from a sale under §121. Thus, in these situations, the holding period is five years and the usage requirement remains two years.

EXCHANGE OF VACATION HOMES

In 2007, the Tax Court ruled that the sale of a vacation home and the purchase of another vacation home did not qualify for like-kind exchange treatment under §1031.[34] The taxpayer unsuccessfully argued that he had an investment motive in purchasing the property because he believed the vacation home would appreciate in value. The Tax Court did not dispute the argument that he purchased the property with the expectation it would appreciate. However, the Tax Court held that the primary use of the property was as a vacation home and the mere hope or expectation of a gain cannot establish investment intent if the property is used as a residence.

Can a taxpayer therefore ever apply §1031 to vacation homes? If the property is only used personally and never rented, it more than likely will not qualify for like-kind exchange treatment. For situations involving both personal and rental use, the IRS has issued guidance and a safe harbor under Rev. Proc. 2008-16, whereby the IRS will not challenge whether a dwelling unit qualifies under §1031 if **qualifying-use standards** are met for the dwelling unit. The revenue procedure is effective for exchanges occurring on or after March 10, 2008. The qualifying-use standards apply to either the relinquished and/or replacement property if either or both are vacation property. The standards are:

- **Relinquished Property.** The dwelling unit must be owned for at least 24 months immediately before the exchange. Within each of the 12-month periods before the exchange, the taxpayer must rent the dwelling to another person for 14 days or more at fair rental value. The amount of the taxpayer's personal use cannot exceed the greater of 14 days or 10% of the number of days rented during each 12-month period.

- **Replacement Property.** The dwelling unit must be owned by the taxpayer for at least 24 months after the exchange. In each of the two 12-month periods immediately after the exchange, the taxpayer must rent the dwelling to another person for at least 14 days or more at fair rental value. The taxpayer's personal use cannot exceed the greater of 14 days or 10% of the number of days rented during each 12-month period. The first 12-month period begins immediately after the exchange and the second 12-month period begins immediately after the first 12-month period ends.

Example 16. Tom exchanges his vacation home for another vacation home. He has met the requirements for the relinquished property, but he must also meet the requirements for the replacement property. The first 12-month period for the replacement property begins immediately after the exchange. During this 12-month period, Tom has rented the property for 180 days at its fair rental value. Therefore, his personal use may not exceed 18 days (the greater of 14 days or 10% of the number of days rented (180 × 10%)). He must meet the same requirement for a second 12-month period.

If the taxpayer assumes the replacement property will meet the qualifying-use standards, he can report a like-kind exchange under §1031 and file a federal income tax return using this assumption. If he subsequently determines the property does not meet the qualifying-use standards, he should file an amended income tax return to report the sale of the relinquished property and omit the like-kind exchange.

34. *Moore v. Comm'r*, TC Memo 2007-134 (May 30, 2007).

RESIDENCES QUALIFYING FOR BOTH LIKE-KIND EXCHANGE AND §121 EXCLUSION

Residences that also have business use of the home or residential rental usage can qualify for like-kind exchange treatment provided that the acquired property, if a residence, also has business use of the home or residential rental usage. Rev. Proc. 2005-14 provides guidance in these situations as to the applications of both §§121 and 1031. The §121 exclusion does not apply to depreciation deductions taken since May 7, 1997. However, the like-kind exchange provisions of §1031 may allow the deferral of the recaptured gain.

The revenue procedure provides the following guidance:

- The §121 exclusion is applied before the like-kind exchange deferral under §1031.
- Under §1031(d), the basis of the business or investment replacement property is the same as the basis of the relinquished property, decreased by the amount of cash received and increased by the amount of gain recognized but excluded under §121.
- Cash or other unlike-kind property received (boot) in the exchange is taken into account only to the extent the boot exceeds the gain excluded under §121.

Example 17. Bill buys his principal residence for $195,000 in 1980. From 1999 to 2007, Bill uses 75% of the house as his residence and 25% of the house as an office. In 2007, Bill does a like-kind exchange for another property that he intends to use as his residence and as an office for his business. In the exchange, Bill receives a residence valued at $475,000 and cash of $20,000 attributable to the relinquished business property. Bill claimed $10,000 of depreciation from 1999 to 2007. The result is illustrated as follows:

	Total Property		75% Residential		25% Business	
FMV residence received		$475,000		$356,250		$118,750
Cash received		20,000				20,000
Amount realized		$495,000		$356,250		$138,750
Basis	$195,000		$146,250		$ 48,750	
Depreciation adjustment	(10,000)		(0)		(10,000)	
Adjusted basis	$185,000	(185,000)	$146,250	(146,250)	$ 38,750	(38,750)
Realized gain		$310,000		$210,000		$100,000
Gain excluded under §121	250,000		210,000		40,000	
Gain deferred under §1031	60,000		0		60,000	
Gain recognized	0		0		0	
Basis in replacement property	415,000		356,250		58,750	

RELATED PARTY CONSIDERATIONS

Like-kind exchange treatment generally does not apply to exchanges between related parties if either party disposes of the property received in the exchange within two years of the date of the last transfer that was part of the exchange.[35] The following are exceptions:

- Transfers occurring after the earliest death of either related party[36]
- Involuntary conversions under IRC §1033, provided the exchange occurred before the threat of imminence of such conversion[37]

In either case, neither the exchange nor the disposition can have as one of its principal purposes the avoidance of federal income tax. This must be established to the satisfaction of the Treasury Secretary.

Related parties for this purpose include the following under IRC §§267(b) and 707(b)(1):

- Members of the family, including brothers and sisters, spouse, ancestors, and lineal descendents
- An individual and corporation in which more than 50% of the stock is owned directly or indirectly by the related parties
- Two corporations in the same controlled group
- A grantor and fiduciary of the same trust
- A fiduciary and beneficiary of the same trust
- A fiduciary of a trust and the fiduciary or beneficiary of another trust when the same person is the grantor of both trusts
- A fiduciary of a trust and a corporation when more than 50% of the value of the outstanding stock is owned directly or indirectly by the trust or grantor of the trust
- A corporation and partnership when the same person owns more than 50% of the value of the outstanding stock and capital interest or profits interest in the partnership
- An S corporation and another S corporation or C corporation, if the same persons own more than 50% in value of the outstanding stock of each corporation
- A partnership (or limited liability company) and a person owning directly or indirectly more than 50% of the capital or profits interest in such partnership
- Two partnerships (or limited liability companies) in which the same persons own directly or indirectly more than 50% of the capital or profits interest in each partnership

35. IRC §1031(f)(1)(C).

36. IRC §1031(f)(2)(A).

37. IRC §1031(f)(2)(B).