

Tax Aspects of Home Ownership

By Michael Schlesinger

Michael Schlesinger examines the recent developments in the area of home ownership.

Buying and selling a home today is no longer a simple task. Now, the homeowner, due to the economic downturn that has affected this country has to worry about foreclosure. Additionally, Congress through the years has been chipping away at the tax benefits of home ownership, so now there is a limit on the deductibility of mortgages, a qualification of what expenses qualify for an interest deduction for an equity line on a primary residence, and tax consequences on a conversion of a primary residence to a rental situation. The purpose of this article is to detail the tax aspects of home ownership so that the reader will have some guide as to charting a course through the tax aspects of home ownership.

First-Time Homebuyer Credit

In an effort to stimulate the economy, effective for residences purchased after December 31, 2008, Congress changed Code Sec. 36 to create a disparity between taxpayers who purchased their homes in 2008 and 2009. Basically, as will be seen by an analysis of the eight changes made to Code Sec. 36, "first-time homebuyers" who purchase their homes

after December 31, 2008, and before December 1, 2009, will receive better tax treatment than those individuals who purchased their primary residence in 2008.

Code Sec. 36(h)

Code Sec. 36(h) extends the first-time homebuyer credit to December 1, 2009.

Code Sec. 36(b)

Code Sec. 36(b) increases the maximum credit amount to \$8,000 (\$4,000 for a married individual filing separately). Note that the IRS issued various question and answers on its Web site (hereinafter, "Q&A") plus Notice 2009-12¹ to explain how unmarried taxpayers allocate the credit permitted them under Code Sec. 36(b)(1)(C). Basically, the Notice, which is geared to the prior credit amount (*i.e.*, a maximum credit of \$7,500; credit phase-out if MAGI exceeds \$75,000 for single taxpayers; \$150,000 for joint filers), states that the homebuyer credit may be allocated between the taxpayers using any reasonable method. A "reasonable method" includes allocating the credit between taxpayers who are eligible to claim the credit based on (1) the taxpayers' contributions toward the purchase price of the residence as tenants in common or joint tenants, or (2) the taxpayers' ownership interests in the residence as tenants in common. To assist taxpayers to understand the operation of Code Sec. 36(b)(1)(C), the IRS set forth seven examples in the Notice. In the examples, there are two unmarried taxpayers, A and B, who:

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- are first-time homebuyers who purchase a principal residence on May 1, 2008;
- do not have modified adjusted gross income (MAGI) in excess of the MAGI threshold; and
- are first-time homebuyers who otherwise satisfy the requirements of Code Sec. 36.

Example 1. A contributes \$45,000 and B contributes \$15,000 towards the \$60,000 purchase price of a residence. Each owns a one-half interest in the residence as tenants in common. Under Code Sec. 36(a), the allowable credit is limited to 10 percent of the purchase price, or \$6,000. A and B may allocate the allowable \$6,000 credit three-fourths to A and one-fourth to B based on their contributions toward the purchase price of the residence, one-half to each based on their ownership interests in the residence, or using any other reasonable method (for example, the entire credit to A or B because both A and B are eligible to claim the entire allowable credit).

Note that for this example to work to ensure that B has a one-half ownership interest, A must have made a gift to B of a quarter interest.

Example 2. A contributes \$10,000 for a down payment towards the \$100,000 purchase price of a residence, and A and B obtain and are jointly liable for a \$90,000 mortgage for the remainder of the purchase price. Each owns a one-half interest in the residence as tenants in common. Under Code Sec. 36(b)(2)(A), the allowable credit is not \$10,000 (10 percent of the purchase price) but is limited to \$7,500 because of the MAGI income limitations. A and B may allocate the allowable \$7,500 credit 55 percent to A and 45 percent to B based on their contributions toward the purchase price, one-half to each based on their ownership interests in the residence, or using any other reasonable method (for example, the entire credit to A or B because both A and B are eligible to claim the entire allowable credit).

Example 3. On April 15, 2008, A pays the entire \$100,000 purchase price of a residence and is the sole owner. Under Code Sec. 36(b)(1)(A), the allowable credit is not \$10,000 (10 percent of the purchase price) but is limited to \$7,500. On May 12, 2008, A transfers a one-half interest in the residence to B as a tenant in common

for \$10,000. A may claim the entire allowable \$7,500 credit. Because B acquired B's interest in the residence from A in part by gift, B's basis in the residence is determined under Code Sec. 1015 by reference to A's basis in the residence. Therefore, B did not purchase an interest in the residence within the meaning of Code Sec. 36(c)(3), and no portion of the credit may be allocated to B because B is not eligible to claim any portion of the credit.

Example 4. A and B each contributes \$50,000 towards the \$100,000 purchase price of a residence and owns a one-half interest in the residence as tenants in common. Under Code Sec. 36(b)(1)(A), the allowable credit is not \$10,000 (10 percent of the purchase price) but is limited to \$7,500. However, B is not a first-time homebuyer within the meaning of Code Sec. 36(c)(1). Therefore, no portion of the credit may be allocated to B because B is not eligible to claim any portion of the credit. A may claim the entire allowable \$7,500 credit.

Example 5. A contributes \$75,000 and B contributes \$25,000 towards the \$100,000 purchase price of a residence, and each owns a one-half interest in the residence as tenants in common. Under Code Sec. 36(b)(1)(A), the allowable credit is not \$10,000 (10 percent of the purchase price) but is limited to \$7,500. A's MAGI is \$100,000 and B's MAGI is \$60,000. Because A's MAGI exceeds the \$75,000 MAGI cap, any portion of the credit allocated to A would be reduced to \$0. A and B may allocate the entire allowable \$7,500 credit to B because B's MAGI is less than the \$75,000 MAGI threshold, and, therefore, B is eligible to claim the entire allowable credit.

Example 6. A and B each contributes \$50,000 towards the \$100,000 purchase price of a residence and owns a one-half interest in the residence as tenants in common. Under Code Sec. 36(b)(1)(A), the allowable credit is not \$10,000 (10 percent of the purchase price) but is limited to \$7,500. A's MAGI is \$80,000 and B's MAGI is \$60,000. Because A's MAGI exceeds the \$75,000 MAGI threshold by \$5,000, any portion of the allowable credit allocated to A will be reduced by one-quarter, \$5,000 (MAGI in excess of \$75,000) / \$20,000. A and B may allocate the allowable

\$7,500 credit one-half to A and one-half to B (\$3,750 each) based on their contributions toward the purchase price of the residence or their ownership interests in the residence. However, A's \$3,750 portion of the credit is limited by Code Sec. 36(b)(2) and is reduced by one-quarter ($\$3,750 \times 0.25 = \937.50) to \$2,812.50 ($\$3,750 - \937.50). Alternatively, A and B may allocate the allowable \$7,500 credit using any other reasonable method (for example, the entire credit could go to B because B's MAGI is less than the \$75,000 MAGI threshold, and, therefore, B is eligible to claim the entire allowable credit).

Example 7. A and B, who are sisters, each contributes \$50,000 towards the \$100,000 purchase price of a residence and each owns a one-half interest as tenants in common. Under Code Sec. 36(b)(1)(A), the allowable credit is not \$10,000 (10 percent of the purchase price) but is limited to \$7,500. A and B purchase the residence from their cousin, C. A, B and C are not related persons within the meaning of Code Sec. 36(c)(5). Therefore, A and B may allocate the allowable \$7,500 credit one-half to A and one-half to B based on their contributions toward the purchase price of the residence or their ownership interests in the residence. Alternatively, A and B may allocate the allowable \$7,500 credit using any other reasonable method (for example, the entire credit could go to A or B because both A and B are eligible to claim the entire allowable credit).

In effect, the IRS in Example 7 is sanctioning income tax allocation among unmarried couples to achieve maximum tax effect, something which other Code sections strike down.²

Tax Pointers for Code Sec. 36 in General

- If an individual owns a primary residence, but has rented it out and lived in an apartment for the last three years, he or she can qualify for the credit if the individual purchases a new primary residence in which to live (Q&A S3).
- The provisions for allocations of the credit between single taxpayers is applicable for purchases made in 2008 (Q&A S2).
- Code Sec. 36(c)(1) prescribes that, for the credit to be applicable, the taxpayer and the taxpayer's spouse must not have an interest in a principal

residence within three years prior to the purchase. But, Q&A S1 details that if in a couple one does not qualify as a first-time homebuyer, and the couple are contemplating marriage, they should do so after they purchase the residence since eligibility for the credit is determined on the date of purchase.

- If an individual would not qualify for the credit (*i.e.*, a parent who currently owns a principal residence) co-signs a mortgage for a child for a principal residence where the child will qualify, the child can claim the entire credit (Q&A S2).
- Code Sec. 36(f)(4)(D) and (g) waives the recapture of the credit for qualifying home purchases after December 31, 2008, and before December 1, 2009. This waiver of recapture applies without regard to whether the taxpayer elects to treat the purchase in 2009 as occurring on December 31, 2008. If the taxpayer disposes of the home or the home otherwise ceases to be the principal residence of the taxpayer within 36 months from the date of purchase, Code Sec. 36(f)(1)'s "accelerated rules" for recapture of the credit will apply. Code Sec. 36(g) provides that this waiver of recapture applies without regard to whether the taxpayer elects to treat the purchase in 2009 as occurring on December 31, 2008:
 - This change to Code Sec. 36 has created a disparity. For taxpayers who purchased homes in 2008 and hold onto them, the government is a long-term creditor; for those purchasing homes in 2009, the government is subsidizing the purchase.
 - Taxpayers contemplating purchasing a home in 2009 and applying the credit to 2008 should apply for an extension for filing their 2008 Form 1040 rather than amending it.
- As this article goes to press, the government is willing to allow Code Sec. 36's first-time homebuyer Credit to be used as part of the down-payment on a residence.

Congress Made Two Changes to Code Sec. 36(d)

First, Congress modified the coordination with the first-time homebuyer credit for residents of the District of Columbia under Code Sec. 1400C by eliminating Code Sec. 36(d)(1) and (2). Effective after December 31, 2008, no credit under Code Sec. 1400C shall be allowed to any taxpayer with respect to the purchase of a residence during 2009 if a credit

under Code Sec. 36 is allowable to such taxpayer (or the taxpayer's spouse) with respect to such purchase. Taxpayers thus qualify for the more generous national first-time homebuyer credit rather than the D.C. homebuyer credit for qualifying purchases in 2009. No credit under Code Sec. 36 is allowed for a taxpayer who claimed the D.C. homebuyer credit in any prior tax year.

Second, Congress removed the prohibition on claiming the credit if the residence is financed by the proceeds of a mortgage revenue bond, a qualified mortgage issue the interest on which is exempt from tax under Code Sec. 103.

Election to Treat Purchase in a Prior Year

Under Code Sec. 36(g), taxpayers can elect to treat a home purchase in 2009 as having been made on December 31, 2008, and the IRS in IR-2009-14³ announced that the increase in credit to \$8,000 applies, not the \$7,500 in existence for 2008.

Additional Standard Deduction

Code Sec. 63(c)(1) and (7) was amended to provide additional assistance to homeowners who own a residence but do not itemize their deductions so that an individual taxpayer's standard deduction is increased for the tax year beginning in 2009 by the lesser of (1) the amount allowable to the taxpayer as a deduction for state and local real property taxes as if the taxpayer itemized deductions, or (2) \$500 (\$1,000 in the case of a married individual filing jointly). The increased standard deduction for real property taxes is also available to tenant-stockholders in a cooperative housing corporation (the deduction would be real estate taxes for which a deduction is allowable to the taxpayer under Code Sec. 216). Code Sec. 63 provides that there is no adjusted gross income (AGI) limitation for claiming this additional standard deduction amount.

This amendment to Code Sec. 63 will most likely benefit homeowners who paid off their mortgage and no longer itemize mortgage interest payments as well as low-income homeowners. The standard deduction for joint filers for 2008 is a maximum of \$11,900; single taxpayers, \$5,950; and head of household, \$8,500.

Tax Pointers

- There is no restriction as to when this additional standard deduction applies. Thus, a taxpayer

could close on a house on December 29 and deduct the real estate taxes allocable to the taxpayer at closing.

- State income tax law has to be consulted since a state may not have the same standard deduction rules as under Code Sec. 63. For instance, Connecticut does not have a standard deduction, and California has its own standard deduction for its income tax purposes.

Home Sale Exclusions

In an effort to stem abuse and balance the budget, Congress altered the rules for sales and exchanges after December 31, 2008, of residences. Code Sec. 121(b)(4)[5](A) states that gain from the sale or exchange of a principal residence allocated to periods of "nonqualified use" is not excluded from gross income. Code Sec. 121(b)(4)[5](C)(i) defines a "period of nonqualified use" to mean any period after December 31, 2008, and before the last day that the taxpayer or the taxpayer's spouse uses the property as a principal residence during which the property is not used by the taxpayer or the taxpayer's spouse as a principal residence subject to exceptions noted below. Examples of such nonqualified use would be use of the home as vacation or rental property.

Exceptions to Nonqualified Use

Code Sec. 121(b)(4)[5](C)(ii) prescribes three exceptions to determine nonqualified use:

- any portion of Code Sec. 121(a)'s five-year "counting" period that is after the last date the property is used as the principal residence of the taxpayer or spouse.
- to any period (not exceeding an aggregate period of 10 years) during which the taxpayer or the taxpayer's spouse is serving on "qualified official extended duty" as a member of the armed forces, as a Foreign Service officer, or as an employee of the intelligence community. Code Sec. 121(d)(9)(c)(i) defines a "period of qualified official extended duty" as any extended duty undertaken by a taxpayer while serving at a duty station at least 50 miles from the taxpayer's principal residence.
- any period (not to exceed two years) that the taxpayer is temporarily absent by reason of a change in place of employment, health or, to the extent provided in regulations, unforeseen circumstances.

Code Sec. 121(b)(4)[5](B) prescribes that gain is allocated between periods of qualified and nonqualified use on the basis of respective amounts of time the property is utilized for qualified and nonqualified uses. To determine qualified and nonqualified use, the amount of gain is multiplied by a fraction, the numerator of which is the aggregate periods of nonqualified use during the period the property was owned by the taxpayer, and the denominator of which is the period the taxpayer owned the property. The following example will illustrate.

Example. Taxpayer purchased a vacation home on January 1, 2006. Taxpayer converts the vacation home to a principal residence on January 1, 2011, moves out of it on January 1, 2014, and sells it at a gain on January 1, 2015, thus owning it for nine years. Taxpayer satisfies Code Sec. 121's basic two-out-of-five-year residency test (2011–2014), but because of the two years of nonqualified use from 2009–2011, Taxpayer has to exclude two-ninths during 2009 and 2010. As to the period 2006–2009, Taxpayer did not occupy the home as a principal residence, but this three-year period is not a period of nonqualified use because it preceded January 1, 2009. Even though Taxpayer did not occupy the home as a principal residence during 2014, that one-year period is not a period of nonqualified use because it followed the last period during which Taxpayer occupied the home as the principal residence. Thus, seven-ninths of the gain remains eligible for the exclusion. If the Taxpayer had purchased the house on January 1, 2009, instead of January 1, 2006, all other facts remaining the same (so that Taxpayer owned the home for six years), made it taxpayer's principal residence as of January 1, 2012, and sold it January 1, 2015, then Taxpayer would be required to exclude one-half of the gain for the three-year period of nonqualified use. One-third of the gain would be ineligible for the exclusion, but two-thirds of the gain would remain eligible for the exclusion.

Ordering rules

In applying the amount of gain required to be included on the sale of the principal residence, Code Sec. 121(b)(4)[(5)](D) sets forth certain "ordering rules" to calculate the gain attributable to post-May 6, 1997, depreciation. The exclusion does not apply to that amount of gain, as under present law, and that gain

is not taken into account in determining the amount of gain allocated to nonqualified use. An example from the Committee Reports illustrate the application of the ordering rules:

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

The changes made to Code Sec. 121's rules regarding nonqualified use could seriously affect individuals nearing retirement who purchase their second home with plans to move to that home on retirement.

Mortgage Forgiveness Debt Relief

Congress attempted to help taxpayers with mortgage foreclosures by amending Code Sec. 108 to exclude from the gross income of a taxpayer any discharge of indebtedness income on or after January 1, 2007, and before January 1, 2010, by reason of a discharge (in whole or in part) of qualified principal residence indebtedness. Code Sec. 108(a)(1)(E) prescribes that qualified principal residence indebtedness means acquisition indebtedness (within the meaning of Code Sec. 163(h)(3)(B)) with respect to the taxpayer's principal residence; however, there is a \$2 million dollar limit (\$1 million for a married taxpayer filing a separate return). Code Sec. 108(h) states that acquisition indebtedness with respect to a principal residence generally means indebtedness that is incurred in the acquisition, construction or substantial improvement of the principal residence of the individual and is secured by the residence. It also includes refinancing of such indebtedness to the extent the amount of the refinancing does not exceed the amount of the refinanced indebtedness. For these purposes, the

term “principal residence” has the same meaning as under Code Sec. 121.

The Committee Reports in amplification of Code Sec. 108 state that if, immediately before the discharge, only a portion of a discharged indebtedness is qualified principal residence indebtedness, the exclusion applies only to so much of the amount discharged as exceeds the portion of the debt that is not qualified principal residence indebtedness. Thus, assume that a principal residence is secured by an indebtedness of \$1 million, of which \$800,000 is qualified principal residence indebtedness. If the residence is sold for \$700,000 and \$300,000 debt is discharged, then only \$100,000 of the amount discharged may be excluded from gross income under Code Sec. 108.

Code Sec. 108(a)(2)(A) details that the debt relief provision of Code Sec. 108 does not apply to a taxpayer in a Title 11 case; instead, the present-law Code Sec. 108(a)(1)(A) exclusion applies. In the case of an insolvent taxpayer not in a Title 11 case, Code Sec. 108(a)(2)(C)(2) details that the Code Sec. 108 exclusion applies unless the taxpayer elects to have the present-law exclusion due to insolvency of Code Sec. 108(a)(1)(B) apply instead. The Committee Reports detail that the discharge of a loan will not be excluded from gross income if it is as a result of services performed for the lender or other factors unrelated to either the financial condition of the taxpayer or a decline in value of the residence.

Rev. Rul. 90-16⁴ prescribes that if the mortgage debt is recourse, then taxable gain would be realized if the recourse debtor transferred the property that was subject to the recourse mortgage to the creditor in full satisfaction of the debt. To illustrate: At the time of the transfer, the debt was \$12,000, the fair market value of the property was \$10,000 and the debtor's basis was \$8,000. Rev. Rul. 90-16 held that the taxpayer had to recognize as gain the difference between the property's fair market value (\$10,000) and the taxpayer's basis (\$8,000) from the disposition of the property, and the difference between the debt (\$12,000) and the property's fair market value (\$10,000) is treated as cancellation of indebtedness income. Since the debtor has to meet the requirements of Code Sec. 121 with respect to defining the residence subject to Code Sec. 108, then Code Sec. 121 will control the amount of gain to be recognized. If the debt is nonrecourse, then the case of *J.F. Tufts*⁵ will control. Accordingly, if the nonrecourse mortgage is discharged in a sale or through foreclosure, the portion of the debt that is forgiven will be treated as an amount realized on the

sale of the property, and the debtor may realize gain on the sale of the property to the extent that the total amount realized on the sale exceeds their basis.

Mortgage Insurance Deduction

In order to provide assistance to homeowners in their purchase of a primary residence, Code Sec. 163(h)(3)(E)(iv)(I) was amended to provide that qualified mortgage insurance premiums may continue to receive treatment as qualified residence interest (*i.e.*, deducted as an itemized deduction) if the premiums are paid or accrued on or before December 31, 2010, and are not properly allocable to a period after that date. For this provision to apply, the requirement that the premiums be paid pursuant to a contract issued on or after January 1, 2007, remains in effect.

Code Sec. 163(h)(4)(E) defines “qualified mortgage insurance” as mortgage insurance provided by the Veterans Administration (VA), the Federal Housing Administration (FHA), or the Rural Housing Administration (RHA), and also private mortgage insurance as defined under Act Sec. 2 of the Homeowners Protection Act of 1998⁶ as in effect on December 20, 2006. Code Sec. 163(h)(4)(F) states that the deduction is subject to a phase out for taxpayers whose adjusted gross income exceeds \$100,000 (\$50,000 in the case of a married taxpayer filing separately).

Exclusion of Gain on Sales of Principal Residences by Surviving Spouses

Code Sec. 121 was amended by Code Sec. 121(b)(4) to correct a legislative oversight for sales or exchanges of principal residences after December 31, 2007, to provide that a sale of a primary residence by the surviving spouse which was jointly owned and occupied by the surviving spouse and deceased spouse. Now, the surviving spouse is entitled to the \$500,000 maximum exclusion of gain from sales or exchanges of principal residences as long as (1) the sale occurs no later than two years after the date of death of such spouse, and (2) immediately before the date of death, either spouse met the two-out-of-five-year ownership requirement, both spouses met the two-out-of-five-year use requirement, and neither spouse was ineligible to claim the exclusion because of another sale or exchange within the prior two years that qualified for the exclusion.

If the taxpayer remarries and sells the home within two years after the date of death of the first spouse, the taxpayer would not be entitled to the new \$500,000 maximum exclusion amount for surviving spouses.

Residential Energy Property Credit

Congress made a number of changes to the residential energy property credit:

- Code Sec. 25C(g)(2) extended the credit to include qualifying property placed in service in 2010.
- Code Sec. 25C(a) increased the credit amount in 2009 and 2010 from 10 to 30 percent of the sum of the amount paid or incurred by an individual for qualified energy efficiency improvements and residential energy property expenditures. The previous 10-percent credits and the limits of \$50, \$100, \$150 for furnaces and \$200 for windows have been eliminated for qualifying expenditures, and now are all eligible for the full 30-percent credit up to the limit of \$1,500. However, lighting is still excluded from the credit.
- Code Sec. 25C(d)(3) energy efficiency building standards have been modified or increased for certain qualified energy efficiency improvements (building envelope components), certain qualified energy property (natural gas, propane, and oil hot water boilers and oil furnaces) and certain energy efficient building property (electric heat pumps, central air conditioners, water heaters) placed in service after February 17, 2009.
- Code Sec. 25C(b) tripled the residential energy property credit from \$500 to \$1,500 for tax years beginning in 2009 and 2010.

If a taxpayer fully utilized the previous \$500 lifetime maximum in 2006 and/or 2007, for the years 2009 and 2010 the taxpayer will be eligible for a residential energy property credit of up to \$1,500 over both years.

Residential Alternative Energy Credit

Congress eliminated the cap on this credit for the years 2009–2016.⁷

Code Sec. 121

Given the current downturn in the market, primary residences are not being sold for a gain, rather with

a nondeductible loss. As the economy improves, Code Sec. 121's provisions will re-enter the picture, especially for situations where people will relocate to take advantage of better job opportunities. Congress has provided in Code Sec. 121(c) a partial exclusion of Code Sec. 121's \$250,000 (\$500,000 if married) gain computed based primarily on the number of days the taxpayer(s) occupy their primary residence during this two-year period over 730 days (365 x 2 = 730). Specifically, Code Sec. 121(c)(2)(B) provides the partial exclusion if "such sale or exchange is by reason of a change in place of employment, health, or, to the extent provided in regulations, unforeseen circumstances."

As to unforeseen circumstances, this is a factual situation, and a review of the private letter rulings issued in the area reveal that the IRS has been somewhat liberal in granting a partial exclusion under Code Sec. 121(c). For instance, in LTR 200820016,⁸ a taxpayer was allowed to exclude gain from sale of principal residence under Code Sec. 121(c)'s unforeseen circumstances when the taxpayer's daughter was subject to school bus bullying. LTR 200745011⁹ allowed taxpayers to utilize Code Sec. 121(c) to take a partial exclusion of gain after the birth of taxpayers' second child because they did not want to convert the home office of the husband into the bedroom for the second child; rather the couple bought a larger house with bedrooms for each child and a home office for the husband.

However, in applying Code Sec. 121's general rules, the U.S. Tax Court has not been so liberal interpreting the rules as the IRS has been with Code Sec. 121(c). This was illustrated in *J.R. Farah*.¹⁰ In *Farah*, a married couple was entitled to exclude up to \$500,000 of gain from the sale of their principal residence under Code Sec. 121; however, the couple was not allowed to exclude gain under Code Sec. 121 from the sale of a lot bordering the residence that was purchased by a family partnership which they formed, as they did not individually own the lot individually at the time of the sale.

Conservation Easements

Code Sec. 170(h) prescribes that a taxpayer can receive a charitable deduction when the land is contributed for conservation purposes for the preservation of land areas, protection of natural habitats and the preservation of open spaces. In *C.F. Glass*,¹¹ a homeowner's grant of two conservation ease-

ments on homeowner's property was sustained as a charitable deduction. The case was somewhat controversial on a number of factors: (1) The relatively small size of property subject to two conservation easements (150 and 260 feet of shoreline, extending inland for 120 feet); (2) there was no evidence that the plant and wildlife habitat could not exist on an area of that size; (3) the easements did not restrict the taxpayers from developing the property provided they followed zoning requirements; (4) the easements allowed taxpayers to continue living on the property and the right to selectively prune, trim or cut trees, shrubs or vegetation with the limited purposes of preserving the scenic view or for safety; (5) the taxpayers also carved out a right to build a shed, boathouse or deck, but this right had to be exercised in a way that minimized interference with the habitat; and (6) the taxpayers had the right to maintain and establish foot paths providing they enhanced the ability of the plant and wildlife habitats to flourish. In reaching its decision, the court noted that the protection of the natural habitat need not be pursuant to a clearly delineated government policy or further a specific conservation project.

Qualified Personal Residence Trust (QPRTs)

A QPRT involves the creation of a trust where a homeowner transfers the full value of the residence for the gift tax imposed on the remainder interest. Besides reducing estate taxes for the homeowner, any appreciation in the value of the residence that occurs after transfer to the trust will not be subject to estate tax inuring for the benefit of the remainder beneficiaries. One of the major attributes of a QPRT compared to an outright gift of the residence is that the homeowner can remain in the home rent-free during the retained term, lease the home or live there as a guest of his or her spouse after the retained term ends (if the spouse is a beneficiary of a trust to which the home passed) while at the same time retaining some degree of control over the home during the retained term.

In recent years, there has been activity in this area as indicated by the private letter rulings issued. For instance in LTR 200626043,¹² a residence trust was sustained when a vacation home was converted to a personal residence. In LTR 200901019,¹³ the IRS held that the transfer of a residence by a QPRT to another QPRT was immune from the harsh transfer

tax under Code Sec. 2702 and, in effect, extended the term interest of the original transfer of the residence. LTR 200919002¹⁴ sustained a transfer of a residence to a trust where the remainder interest was sold to a second trust and no gift tax arose on the sale. The IRS recently approved, in LTR 200904022¹⁵ and LTR 200904023,¹⁶ a QPRT created by the remaindermen of an earlier QPRT where the remaindermen provided a lifetime right to reside in the residence to the original donor with the original QPRT modified to permit outright distribution of the residence to the remainder beneficiaries (children of the original donor) who then created a QPRT for the benefit of the original donor-parent.

Code Sec. 1031

As a general rule, personal residences cannot be swapped tax-free under Code Sec. 1031; however, with vacation homes, they can be swapped if certain conditions can be met. Rev Proc 2008-16¹⁷ sets forth a safe harbor for the tax-free swap. The IRS issued this safe harbor because it realized that many taxpayers hold dwelling units [including vacation homes] primarily for the production of current rental income, but also use the properties occasionally for personal purposes. Rev. Proc. 2008-16, §3.02, states that this Code Sec. 1031 safe harbor will apply to any dwelling unit, *i.e.*, "real property improved with a house, apartment, condominium, or similar improvement that provides basic living accommodations including sleeping space, bathroom and cooking facilities." To be eligible for a Code Sec. 1031 swap, the property has to meet certain conditions, namely, the ones prescribed in Rev. Proc. 2008-16, §4.02:

- The dwelling unit is owned by the taxpayer for at least 24 months immediately before the exchange (the "qualifying use period").
- Within the qualifying use period, in each of the two 12-month periods immediately preceding the exchange, the following must occur:
 - The taxpayer rents the dwelling unit to another person or persons at a fair rental for 14 days or more.
 - The period of the taxpayer's personal use of the dwelling unit does not exceed the greater of 14 days or 10 percent of the number of days during the 12-month period that the dwelling unit is rented at a fair rental. (For

this purpose, the first 12-month period immediately preceding the exchange ends on the day before the exchange takes place (and begins 12 months prior to that day), and the second 12-month period ends on the day before the first 12-month period begins (and begins 12 months prior to that day).)

Replacement Property

A dwelling unit that a taxpayer intends to be replacement property in a Code Sec. 1031 exchange qualifies as property held for productive use in a trade or business or for investment if the following applies:

- The dwelling unit is owned by the taxpayer for at least 24 months immediately after the exchange (the “qualifying use period”).
- Within the qualifying use period, in each of the two 12-month periods immediately after the exchange, the following occurs:
 - The taxpayer rents the dwelling unit to another person or persons at a fair rental for 14 days or more.
 - The period of the taxpayer’s personal use of the dwelling unit does not exceed the greater of 14 days or 10 percent of the number of days during the 12-month period that the dwelling unit is rented at a fair rental. (For this purpose, the first 12-month period immediately after the exchange begins on the day after the exchange takes place, and the second 12-month period begins on the day after the first 12-month period ends.)

Rev. Proc. 2008-16, §4.03, states that “personal use” of a dwelling unit occurs on any day on which a taxpayer is deemed to have used the dwelling unit for personal purposes under Code Sec. 280A(d)(2) (taking into account Code Sec. 280A(d)(3) but not Code Sec. 280A(d)(4)). A “fair rental” is determined per Rev. Proc. 2008-16, §4.04, based on all of the facts and circumstances that exist when the rental agreement is entered into.

Levy of a House for Unpaid Taxes

Congress in the Taxpayer Bill of Rights set up a number of procedural steps to safeguard a taxpayer’s primary residence from levy and seizure. Two recent cases detail that while the IRS may have the power and proceed correctly to levy and seize property, the courts still have great concern;

so the IRS has been forced to work with taxpayers to let them remain in the residence. In *W.F. Johns*,¹⁸ the IRS could not foreclose on the entire property owned by a delinquent individual and his ex-spouse in light of equitable considerations. The property in question was owned by a divorced couple as tenants in common, and the ex-wife resided on the property for 16 years. The foreclosure arose from unpaid income taxes of the taxpayer’s former husband, which arose prior to the divorce. The taxpayer was unemployed and on disability due to breast cancer and other injuries; had no sources of income other than the disability payment; and her only assets were a savings and checking account with a \$350 balance. When the foreclosure notice was issued, the taxpayer made her first appearance, advising that she had “been extremely ill for a long period of time and did not recognize the significance of the government’s attempt to sell her interest in the property.” The taxpayer agreed that the government could foreclose on the property even though she was not responsible for her ex-husband’s delinquent taxes. However, the court felt that it would constitute a significant hardship and result in substantial prejudice if the taxpayer was forced out of her home so that the government could collect on a 14-year old tax debt for which she was not liable. Additionally, the court noted that while the taxpayer would be entitled to her share of the proceeds when the property was later sold, it also recognized that it could not be “blind to the fact that in practical terms financial compensation may not always be a completely adequate substitute for a roof over one’s head.” Rather than subdivide the property, the court concluded “that the entire property should not be foreclosed.”

In *R.A. Peterson*,¹⁹ the court approved a levy of taxpayer’s home for unpaid outstanding tax liabilities. However, the taxpayer said that he was (1) working hard to pay them off and had paid over \$80,000 toward his tax liability in the past 20 months, and (2) trying to obtain a loan on the home to permit him to pay his tax debt. While the court approved the levy, the IRS advised the court that it would work with the taxpayer to avoid a forced sale of his home.

Conclusion

As this article has briefly detailed, owning a dwelling unit today from a tax perspective is a complicated and complex matter. Before the recent downturn in

the market, pursuing the American dream of owning a house was basically a “win-win” situation with the only concern being basically how can a taxpayer trade up housing without incurring income tax along the way. Now, with the real estate market extremely depressed, the focus of Congress is how to help taxpayers stay in their residences and if they are forced

to abandon them, minimize the tax effect of their loss. Additionally, in an attempt to “jump start” the market as well as stop the downward spiral, Congress has revised the first-time housing credit so that first-time homeowners will want to enter the real estate market and be able to afford the American dream: a house of their own.

ENDNOTES

¹ Notice 2009-12, IRB 2009-6, Jan. 15, 2009.

² See, e.g., Code Sec. 482.

³ IR-2009-14 (Feb. 25, 2009).

⁴ Rev. Rul. 90-16, 1990-1 CB 12.

⁵ *J.F. Tufts*, SCt, 83-1 USTC ¶9328, 461 US 300.

⁶ Homeowners Protection Act of 1998 (P.L. 105-216).

⁷ Code Sec. 25D.

⁸ LTR 200820016 (Feb. 7, 2008).

⁹ LTR 200745011 (Aug. 13, 2007).

¹⁰ *J.R. Farah*, 94 TCM 595, Dec. 57,203(M), TC Memo. 2007-369.

¹¹ *C.F. Glass*, CA-6, 2007-1 USTC ¶50,111, 471 F3d 698.

¹² LTR 200626043 (Feb. 23, 2006).

¹³ LTR 200901019 (Sept. 26, 2008).

¹⁴ LTR 200919002 (Dec. 23, 2008).

¹⁵ LTR 200904022 (Sept. 30, 2008).

¹⁶ LTR 200904023 (Sept. 30, 2008).

¹⁷ Rev. Proc. 2008-16, IRB 2008-10, 547.

¹⁸ *W.F. Johns*, DC-FL, 2007-1 USTC ¶50,316.

¹⁹ *R.A. Peterson*, DC-CA, 2009-1 USTC ¶50,238.

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