Buy, Sell, Exchange, Rent, Share, Use, Hold, Convert - Tax Considerations of Residential Properties

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Introduction

This presentation and outline reviews the tax rules that pertain to use of a residence as a personal home, vacation home, or rental property, as well as various planning options for maximizing after-tax income on various forms of residential investments. Key topics covered include:

a. Gain exclusion under §121.

b. Potential limitations of §§280A, 469, 212, and 183 applicable to rental of a residence.

c. Tax rules and issues of converting a residence from rental to principal residence, or vice versa.

d. Rules and issues pertaining to co-ownership of a principal residence, as well as to debt investments in a principal residence (these transactions are typically entered into by "investors" to assist a relative or employee acquire a principal residence).

Residential Properties – Buy, Use, and Hold

I. Overview

There are a variety of tax benefits and limitations that apply to owners of residential properties. Application of these rules first requires that the nature of the property be identified. For example, if a property meets the definition of a principal residence, there is potential for exclusion of all or part of any gain from disposition of the residence. If a property is a vacation home, the owner may be able to deduct mortgage interest on it if it is a "second residence" under §163(h). If the home is rented out, the tax rules of §280A(d) or §469 may apply to limit the deductibility of losses from operating the property depending on the amount of personal use of the residence. Rental properties will also generate depreciation deductions.

A residence may be of mixed use, such as part principal residence and part rental or home office. Special rules exist under §280A and related regulations, as well as Reg. §1.163-10T(p)(4), to assist the owner in determining how to allocate deductible expenses between the two uses. In addition, upon disposition, the owner will need to allocate the basis and selling price between the different uses to determine the tax consequences (with scant guidance available on how to make the allocation).[1] The residence may have a loss associated with it that is being carried forward under either §469 or §280Ac)(5) and the owner will need to determine the tax treatment of the loss upon disposition of the residence (these rules are not entirely clear in the IRC).

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[1] Prop. Reg. §1-280A-2(i)(3) provides that a taxpayer may determine the expenses allocable to the portion of a home used for business purposes by any reasonable method. An allocation based on floor space used in the business activity compared to total floor space of the home is used as an example of a reasonable method. In TAM 7935003, the Service used the §280A(c)(5) allocation percentage to determine how much of the disposition gain fell under §1034. Also see *Poague v. U.S.*, 66 AFTR 2d 90-5825, 90-2 USTC P50,539 (ED VA), aff'd by 4th Cir. 1991 in unpublished opinion; and *Wigfall v. Comm'r.*, T.C. Memo 1982-171.

II. Principal Residences

There are several tax advantages of owning a principal residence:

a. Deductibility of property taxes for owners who itemize their deductions.

b. Deductibility of interest expense if the requirements of §163(h) are met.

c. Ability to obtain tax-deductible interest on a home equity loan (§163(h)(3)).

d. Exclusion of gain from sale or exchange if all the requirements of §121 are met.

Principal Residences – Sell or Exchange

I. Basics of §121

Reasons for Change: The Taxpayer Relief Act of 1997 eliminated the gain deferral rule of §1034 and made significant changes to §121, both dealing with sale of a principal residence. The primary reason behind these changes was to simplify recordkeeping. Under prior law, basis records for prior residences owned by an individual had to be maintained if the current residence was acquired as part of a §1034 gain deferral transaction. Yet, most homeowners never paid income tax on the gain from sale of their principal residence because of the gain exclusion and deferral provisions. The expansion of §121 also reduces the need to distinguish between capital expenditures and repairs with respect to a principal residence.

Another rationale for expanding §121 was to eliminate the need for individuals to purchase a replacement home costing at least as much as the adjusted sales price of their prior home in order to defer their entire gain. Under the new provision, tax considerations should neither influence the price range of replacement homes that individuals consider for purchase nor promote an "inefficient use of ... financial resources" (per House Report No. 105-148, page 347). In addition, prior law may have discouraged some older individuals from selling their homes if they had already used the §121 lifetime exclusion or had a gain greater than the $125,000 limitation. In such instances, these older individuals would be encouraged to remain in their homes to prevent recognizing a gain even though the home "no longer suits their needs." Thus, the change may eliminate a "constraint to the mobility of the elderly."

Revised §121 was also designed to eliminate the "tainted spouse" problem. Under prior §121, if an individual married someone who had previously used §121, the individual was precluded from using §121, even though he may not have used it prior to marriage.

Basics of the gain exclusion: Under new §121(a), if an individual has owned and used a home as his principal residence for periods aggregating at least two years of the five-year period ending on the sale or exchange date, he may exclude up to $250,000 of the gain ($500,000 if married filing jointly). For married taxpayers filing jointly in the year of the sale or exchange to obtain the larger exclusion amount, only one spouse needs to meet the ownership requirements, but both spouses must meet the use requirement. Also, to obtain the larger exclusion amount, neither spouse must be ineligible for the gain exclusion by reason of the exclusion having applied to another sale or exchange during the prior two years. If only one spouse meets both the ownership and use requirement, the couple may exclude only up to $250,000 of gain (for the higher exclusion to apply, both spouses must meet the use requirement and neither spouse could have been eligible to apply the exclusion to another residence sale or exchange in the prior two years).

A husband and wife filing jointly who each own a principal residence and individually satisfy the ownership and use requirements with respect to their homes, may each exclude up to $250,000 of gain upon sale or exchange of their homes (as they could if they were not married and instead filed separate returns). In such a situation, the one sale every two years limitation will not apply.

Per new §121(g), the ownership and use period of a principal residence includes the period an old residence was owned and used if gain was previously deferred under §1034 as it existed prior to its repeal. Also, if old §1034 was previously applied to a residence, its basis is still determined under old section 1034(e) (per section 1016(a)(7)).

Limitations under §121: Various limitations exist under new §121. If the two out of five-year ownership and use requirements are not satisfied, generally any realized gain upon sale or exchange must be recognized. Also, if during the two-year period ending on the sale or exchange date, there was any other sale or exchange to which the exclusion applied (other than a sale or exchange before May 7, 1997), no exclusion is allowed. However, an exception applies if the owner is forced to move, such as because of a "change in place of employment, health, or, to the extent provided in regulations, other unforeseen circumstances." When a "forced" sale occurs, the maximum exclusion amount is adjusted to reflect the fraction of the two-year ownership and use requirement that was satisfied. If there is more than one sale or exchange during a two-year period, and the later sale is not a "forced" sale, the gain cannot be excluded under §121 (but see special transitional rule below). Similarly, if the two out of five year ownership and use requirements are not met and the sale is not a "forced" sale, any gain must be recognized. Such gains are recognized even if the seller reinvests all sales proceeds in a replacement residence (because §1034 is repealed).

> Example 1: Eric purchased a home on October 1, 1999 for $200,000 and sold it on October 2, 2000 for $300,000 when his employer transferred him to a new work location. If Eric had sold the home at a time when he met the 2 out of 5 years of ownership and use requirement, he would be eligible to exclude up to $250,000 of his gain. However, because the sale was due to a change in his work location, he is allowed a $125,000 maximum exclusion (he has met 1 year of the 2 year use and ownership requirement). Thus, Eric may exclude his entire gain.

> Example 2: Same facts as in (1) except that Eric originally purchased the home for $2,000,000 and sold it for $3,000,000. Eric will only be able to exclude $125,000 of his gain. The remainder is taxable at 20%.

Special rules in cases of divorce: Per §121(d)(3)(A), if an individual holds a residence transferred to her incident to divorce, the period she owns the property shall include the period the spouse or former spouse owned it.

New §121(d)(3)(B) provides a beneficial rule for a divorced spouse who moves out of his principal residence, but continues to own it. Under this provision, an individual is treated as using property as his principal residence during any period of ownership while his spouse or former spouse is granted use of the residence under a divorce or separation instrument (per §71(b)(2) definition).

Death of a spouse: An unmarried individual's ownership and use period includes the time the individual's deceased spouse owned and used the property prior to death (Section 121(d)(2)). However, bear in mind that the larger gain exclusion for married individuals only applies if a joint return is filed.

Depreciation: The excludable gain must be reduced for depreciation adjustments attributable to periods after May 6, 1997. Under §1(h), this portion of the gain is generally taxable at a tax rate of 25%.

Involuntary conversion: In addition to sale or exchange of the residence, the gain exclusion also applies to gain resulting from the destruction, theft, seizure, requisition or condemnation of the property. In applying the §1033 involuntary conversion provision, the amount realized is treated as the amount determined without regard to §121, reduced by the amount of gain not included in gross income pursuant to §121. Where the basis of the property sold or exchanged is determined under the §1033(b) basis rule, the holding and use by the individual of the converted property is treated as holding and use by the taxpayer of the property sold or exchanged.

More special rules: Special rules are provided for cooperative housing, periods of non-use due to the physical or mental incapacity of the owner, sales of remainder interests, and expatriates. Generally, the gain exclusion also applies to holding of stock in a cooperative housing corporation and use of the house or apartment to which the shareholder was entitled to occupy.

If an individual becomes physically or mentally incapable of self-care and owned and used his residence for periods totaling at least one year during the 5-year period prior to sale or exchange, he will be treated as using the residence as a principal residence during any time during that period in which he owns it, but resides in a facility (including a nursing home) licensed by a State or political subdivision to care for individuals in his condition.

The special rule for remainder interests is an elective one. The §121 exclusion may apply to a sale or exchange of an interest in a principal residence even if such interest is a remainder interest. However, §121 will not apply to any other interest in such residence that is sold or exchanged separately. An exception exists for certain sales or exchanges to related persons.

The gain exclusion rule does not apply to any sale or exchange by an expatriate individual to which §877(a)(1) treatment applies.

Election out: IRC §121 is worded as a mandatory provision. However, per §121(f), an individual may elect not to apply the exclusion to any sale or exchange of a principal residence. This election out may be appropriate where an individual has sold two principal residences within two years, neither is a "forced" sale, and the individual gain on the second sale is larger than on the first (and so the taxpayer should elect not to apply §121 to the first gain).

Reporting: IRC §6045(e) was modified to eliminate the need for a Form 1099 to be issued by a broker (per §6045(c)(1)) in situations where it is unlikely that the selling homeowner would have a gain to report. No reporting is required if the sales price of the residence is $250,000 or less and the broker receives written assurance from the seller that the residence is a principal residence, there is no federally subsidized mortgage financing assistance (if such information is required by the Service) and the full gain is excludable under §121. Where the assurance from the sellers includes that they are married, the sales price can be $500,000 or less without a need for a reporting form to be issued by the broker.

Form 2119 is now obsolete. If some portion of the gain from sale or exchange of a principal residence is taxable, it is to be reported on Schedule D. See new IRS Publication 523, *Selling Your Home*.

Effective date: The new gain exclusion provision is generally effective for sales and exchanges after May 6, 1997. For sales and exchanges prior to the enactment date (August 5, 1997), a taxpayer may elect not to apply the amendments made by the Act. Binding contract exceptions also exist. Individuals could elect to apply old §§121 and 1034 to a sale or exchange made after the enactment date if pursuant to a binding contract in effect on the enactment date. Also, a taxpayer could elect to apply the former provisions where the replacement residence was acquired on or before enactment date (or pursuant to a binding contract in effect on that date) and old §1034 would apply.

Finally, if a principal residence owned on August 5, 1997 is sold within two years of that date, but the ownership and use requirements of new §121(a) are not satisfied, the prorated gain exclusion rule applies, even if it is not a forced sale.

Definition of a "principal residence," "use," and "ownership:" While new §121 uses the term "principal residence" that was also used in old §1034, it is questionable whether all parts of that definition are still to be used. In addition, "use" of a residence is not clear. The legislative history to the 1997 Act uses the term "occupied" and the statute is not specific. Under old §§1034 and 121, temporary absences could be ignored in determining whether the residence was a principal residence. In *Gummer v. U.S.,* 81 AFTR2d 98-1740, 40 Fed Cl. 812, the court held that "use" for pre-TRA'97 §121 purposes should follow the facts and circumstances determination under §1034, rather than requiring strict physical occupancy. Guidance is needed to both define "principal residence" and explain "use" of a residence. Will temporary absences count as "use" under §121, or is a different intent required by use of the word "occupied" in the legislative history. It would probably also be helpful for the Service to define "ownership" for §121 purposes. A recent case explained the importance of this term as used in pre-TRA'97 §121. In *Blanton v. Comm'r.*, T.C. Memo 1998-211, the exclusion of old §121 was denied to taxpayers because although they used the property for three of five years, they did not have title for 3 years. Neither did they have enough benefits and burdens of ownership to be treated as owning the property prior to title passage.

II. Tax Planning

Some of the tax planning considerations and cautions under new §121 include:

- As the appreciation in a principal residence approaches the applicable exclusion limit ($250,000 or $500,000), the owner should consider selling it to maximize the tax benefits of §121. Of course, the costs of selling the old house and buying a replacement house should be factored in.
- Don't get new §121 mixed up with elements of old §1034 that are likely entrenched in the minds of many tax practitioners. For example, under old §1034, the home had to be a principal residence at the disposition date. This is not the case under new §121 where the house must only be used as a principal residence for some two-year time period during the five years preceding the disposition date. This could be relevant when a principal residence is converted to rental property and sold within 36 months.
- Be mindful of the timing of dispositions where individuals own more than one home. For example, because an individual could have two residences that meet the gain exclusion rule (e.g., one home was used as a principal residence in 1998 and 1999 and the other in 2000 and 2001 and the individual wants to sell both in 2002), the timing of the dispositions is important to be sure that §121 can be applied to both. A husband and wife who each have a principal residence should also consider the use and timing restrictions so that upon disposition, if needed, the $500,000 exclusion can be used rather than only $250,000.
- Consider converting vacation and rental homes to principal residences more than two years prior to sale. Taxpayers will also want to consider use of §121 for principal residences converted to rental use within the past three years. See the next two sections for more information.

Conversions: Investment Residence → Principal Residence

Owners of vacation and rental homes may want to consider converting them into a principal residence and use them as such for at least two years prior to selling them to take advantage of the fact that there is no limitation on how many times §121 may be used in one's lifetime.

If a rental home is converted to a principal residence and has suspended passive activity losses, such losses will not be triggered upon disposition of the residence due to §469(g)(1), although they continue to be usable against passive activity income (PAI). In converting a rental property to a principal residence, consideration should be given to various §469 rules including the rule on substantially appreciated property, the 12-month lookback rule, and PAI recharacterization rules (the gain due to depreciation required to be recognized under §121(d)(6) may not be PAI).

Conversions: Principal Residence → Investment Residence

Basis: To avoid deduction of a loss on personal use property, when property is converted from personal use to business use, the adjusted basis of property will be the lesser of the fair market value at the conversion date or the adjusted basis at the conversion date.[2] Similarly, for depreciation purposes, the basis of the property converted from personal to business use is the lesser of the FMV or adjusted basis at the conversion date.[3]

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[2] Reg. §1.165-9(b).
[3] Reg. §1.167(g)-1.

§121 May Still Be Available: Under new §121, an individual may still be able to take advantage of the gain exclusion of §121 even though the property was rental property at the date of sale. For example, Jane uses a home as a principal residence for eight years and converts it to rental property when she gets married. If Jane sells the home within three years of the conversion, she will still qualify for the exclusion. Since only Jane, and not her husband has used the property, the maximum exclusion would be $250,000. Any gain attributable to depreciation would not be excludible and would be taxed at a 25% rate. As discussed in the next section, Jane would want to be cautious of the §469 rules and whether she will have any remaining suspended PAL after the disposition. The gain not excludible due to depreciation may qualify as PAI (subject to gain recharacterization rules of Reg. §1.469-2 and –2T).

Conversion When Appreciation Exceeds §121 Dollar Limitations: When an individual's appreciation in their home exceeds $250,000 (or $500,000 is married filing jointly), she may want to consider using a like-kind exchange (§1031) to maximize exclusion and deferral of the gain. "The benefits of Section 121 and Section 1031 do not appear to be mutually exclusive. Indeed, new Section 121 obviously contemplates its application to property that no longer represents a taxpayer's principal residence. Why else would Congress have allowed the application of Section 121 when a property may have ceased being used as the taxpayer's residence up to thirty-six months earlier?"[4]

Arguably, if a residence is entirely converted to rental use and exchanged under §1031 within 36 months of the conversion, up to $250,000 of boot ($500,000 if MFJ) can be received and excluded under §121. Also, where a portion of a principal residence is converted to rental use, a §1031 exchange within 36 months of the conversion should enable the owner to obtain another rental property and a principal residence and maximize gain exclusion and deferral under §121 and §1031.[5]

> Example: Mr. and Mrs. Smith purchased their home over 20 years ago for $20,000. Today, the FMV of the home is $720,000. To maximize their gain exclusion/deferral, the Smiths are considering converting 25% of their home to rental property and use it as such for over a year. Assume the FMV remains at $720,000 one year later, $200 of depreciation has been claimed, and that the Smiths exchange the house for (1) a new home valued at $300,000, (2) rental property (or any like-kind property) valued at $180,000, and (3) $240,000 of cash. The realized gain on the principal residence portion of the house is $525,000 ($540,000 amount realized less basis of $15,000). They exclude $500,000 under §121 and pay tax on the remaining gain of $25,000 at a 20% rate. The basis of their new residence is $300,000.
>
> With respect to the rental portion of the home, the entire gain is deferred under §1031 and the basis of the rental property is $4,800. Pending any change in the law (see below), the Smiths might later convert the rental property to a principal residence and sell the property excluding the gain under §121 (assuming all of the requirements of §121 are satisfied).[6]

Issues with the use of §1031 and §121 include the long-standing question of how long the property must be used as rental/business before and after the exchange to qualify for gain deferral under §1031. Also, guidance from the Service would be helpful to clarify that tandem use of §121 and §1031 is within the intent of new §121 (however see comment below). For example, might the step transaction doctrine apply to the transaction? Might a rental be viewed as temporary and be considered "use" under §121, rather than having converted the property into business or investment property for §1031 purposes? Finally, Congress is aware of the potential to maximize gain exclusion by using §1031 along with §121 when appreciation exceeds the §121 dollar limits. H.R. 2488 (106th Cong.) included a provision (Sec. 1510) to add §121(d)(9):

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[4] Quote from Annette Nellen and Ron Platner, "Disposition of a Principal Residence After TRA'97: Perspectives, Planning, and Problems," *The Journal of Real Estate Taxation*, Summer 1998, page 319, 326.

[5] See Rev. Rul. 59-229, 1959-2 C.B. 180, for an example of such an exchange.

[6] Example taken from "Disposition of a Principal Residence After TRA'97: Perspectives, Planning, and Problems," pages *supra*.

> “Like-Kind Exchanges – Subsection (a) shall not apply to any sale or exchange of a residence if such residence was acquired by the taxpayer during the 5-year period ending on the date of such sale or exchange in an exchange in which any amount of gain was not recognized under section 1031.”

This change has not been enacted (as of September 15, 2000). While it would alter the use of §121 and §1031, it does not prohibit their tandem use and arguably, lends support to the theory that these provisions can be used together.

For more information on the combined use of §121 and §1031, see Annette Nellen and Ron Platner, “Disposition of a Principal Residence After TRA’97: Perspectives, Planning, and Problems,” *The Journal of Real Estate Taxation*, Summer 1998, page 319.

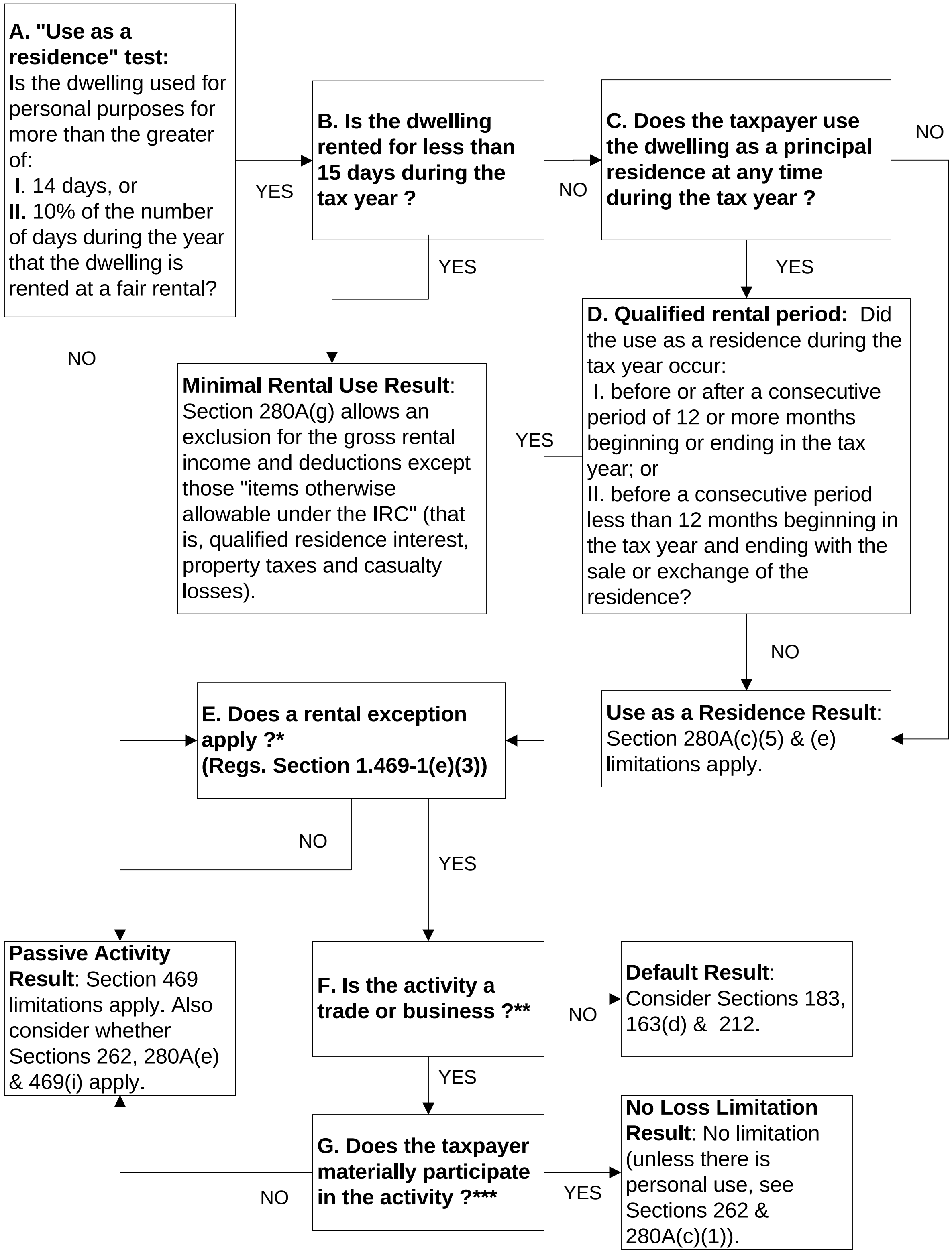
Rental of a Residence

There are a variety of IRC provisions that may apply to an individual who rents out a residence. Most of these provisions limit the individual's ability to deduct losses generated from the rental activity. The potentially applicable provisions include §469 (passive activity loss limitation), §280A (limitation or disallowance of certain expenses in connection with use of a residence for business or rental), §67 and §183 (limitation on expenses of an activity not engaged in for profit), §212 and §67 (limitation on expenses of producing income), and §163 (interest expense limitations).

The rules relevant to rental of a residence are presented in a flowchart[7] to illustrate how these rules interact. The flowchart is designed to assist in determining what possible limitations (if any) apply to the investment activity.

[7] The flowchart is based on one first published in "Rental of Residences," by Bomyea (Nellen) and Marucheck, published in *The Tax Adviser*, September 1990. The full text of the article should be reviewed for further details on the various steps.

Flowchart — What Limitations (if any) Apply to the Rental of a Dwelling Unit, Rented or Held for Rental, at Fair Rental?



Notes to Flowchart

"Use as a Residence Result" - Basics of §280A(c)(5) and (e)

Where an individual or S corporation owner of a dwelling unit[8] uses it as a residence (§280A(d)), the deduction limitation and allocation rules of §280A(c)(5) and (e) will apply. The "use as a residence" definition is met where personal use[9] of a dwelling unit exceeds the greater of (A) 14 days or (B) 10% of the "fair rental"[10] days. The operation of these rules is illustrated by the following example.[11]

> Example: C owns a second home at the beach. C and her family use the house for 20 days in 1990. C has a rental agent rent it out wheever possible during the remainder of the year. There are 100 fair rental days in 1990. Thus, Sec. 280A(c)(5) applies. The income and expenses of the beach house in 1990 are categorized as follows.[a]

Gross rental receipts	$5,000
Less expenditures to obtain tenants (such as rental commissions and advertising)	400
Gross rental income[b]	4,600
Items otherwise allowable under the Code:[c]	
Mortgage interest (loan balance $100,000)	4,000
Property taxes	2,000
Total	6,000
Rental expenses other than depreciation:[d]	
Insurance	500
Repairs and maintenance	500
Utilities	600
Total	1,600
Depreciation[e]	2,000

> C owns only a principal residence with a $200,000 mortgage and the beach house. Under the court cases and proposed regulations, the deductions are calculated and allowed in the following order.

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[8] Per §280A(f)(1), "dwelling unit" includes "a house, apartment, condominium, mobile home, boat, or similar property, and all structures or other property appurtenant to such dwelling unit." It "does not include that portion of a unit which is used exclusively as a hotel, motel, inn, or similar establishment." Prop. Reg. §1.280A-1(c) further adds that the unit must provide "basic living accommodations such as sleeping space, toilet, and cooking facilities." Also, a single structure may include more than one dwelling unit.

[9] "Personal use" is defined at §280A(d)(2) and (3) and Prop. Reg. §1.280A-1(e)(1) and includes days used by the owner and co-owners, days used by a relative unless used as a principal residence, days used by a person who exchanged use of another dwelling with the owner, and days rented out at less than fair rental. Special rules apply when days of use were to perform repairs.

[10] Rental at "fair rental" is necessary to avoid having that rental day count as personal use of the owner. The IRC and regulations do not define fair rental. However, a 1981 clarification to §280A included some guidance on the definition in the legislative history (Staff of the Joint Committee on Taxation, 97th Cong. 1st Sess., *Summary of H.R. 5159: The Black Lung Benefits Revenue Act of 1981*). The existence of fair rental depends on two factors: 1) comparable rents in the area, and 2) whether substantial gifts were made by the taxpayer to the family member at or about the time of the lease, or periodically during the year. Case law has supported a reduction to market rent where the tenant is a family member (because operational costs are likely reduced in such situations). See *Bindseil*, T. C. Memo 1983-411.

[11] Taken from "Rental of Residences," Page 541, *supra*.

Gross rental income	$4,600
Expenses by category:[f]	
Items otherwise allowable under the Code $6,000 x 100/365	(1,644)
Rental expenses other than depreciation $1,600 x 100/120	(1,333)
Depreciation $2,000 x 100/120	(1,667)[h]
Disallowed loss to be carried forward to 1991	($44)

[a] Prop. Regs. Sec. 1.280A-3(d).

[b] Prop. Regs. Sec. 1.280A(d)(2).

[c] Prop. Regs. Sec. 1.280A(d)(3)(i).

[d] Prop. Regs. Sec. 1.280A(d)(3)(ii).

[e] Prop. Regs. Sec. 1.280A(d)(3)(iii).

[f] Sec. 280A(e)(1) and Prop. Regs. Sec. 1.280A-3(d)(3) specify that the portion of expenses attributable to rental use is based on the ratio of fair rental days to the number of days the unit is used for any purpose (other than repair or maintenance) during the tax year. According to sec. 280A(e)(2), Sec. 280A(e)(1) does not apply to expenses otherwise allowable under the Code. In this example, the ratio is 100/120 for the rental-type expenses. The Tax Court has allowed the ratio for items otherwise allowable under the Code to be total fair rental days to days in the tax year since these items accrue ratably during the year, while expense such as utilities and maintenance are more directly related to actual use of the dwelling. See *Bolton*, 694 F2d 556 (9th Cir. 1982); *Baker*, T.C. Memo 1983-61; *McKinney*, 734 F.2d 414 (10th Cir. 1983). The Tax Court formula was used in the example.

[g] The balance of $4,356 is deductible on Schedule A, Form 1040 under Secs. 163(h) and 164. The beach house mortgage interest attributable to the nonrental days is deductible as qualified residence interest since the house qualifies as C’s second residence and the other requirements and limits of Sec. 163(h)(3) and (4) are met.

[h] There is no definitive guidance on whether basis must be reduced by $1,667 or by $1,623, the amount actually allowed. See Regs. Sec. 1.167(a)-10 and 1.183-1(b)(2)(ii); Secs. 280A(f)(3) and 1016(a)(2); and IRS Letter Ruling 8029030 (4/22/80).

Additional points regarding §280A(c)(5):

- Per §469(j)(10), where §280A(c)(5) applies to a dwelling unit, the §469 loss limitations will not apply.
- The limitation does not apply solely to vacation homes, but can apply to any dwelling unit for which the owner meets the use as a residence test.[12]

Passive Activity Result – Basics of §469

Under §469, certain taxpayers are not allowed to deduct a passive activity loss (PAL) or credit. However, such losses and credits may be carried forward to be used against future passive activity income or tax attributed to such income. A passive activity is either a trade or business in which the taxpayer does not materially participate, or any rental activity.

* §469 Rental Exceptions

A rental activity involves the taxpayer holding tangible personal property for use by customers where amounts are received for customers' use of such property. Reg. §1.469-1T(e)(3) provides six rental exceptions where, even though the taxpayer receives income from customers' use of property, the activity is not treated as a rental activity under §469. Thus, such an activity is only a passive activity if it is a trade or business in which the taxpayer does not materially participate. The six rental exceptions are listed below. The first two are the ones most likely to potentially apply with respect to rental of a residence.

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[12] See *Gilchrist*. T.C. Memo 1983-288 and *Kotowicz*, T.C. Memo 1991-563.

1) Average period of customer use is seven days or less.

2) The average period of customer use is 30 days or less and significant personal services are provided by or on behalf of the property owner.

3) Extraordinary personal services are provided by or on behalf of the property owner in connection with making the property available for use by customers.

4) The rental of the property is treated as incidental to a nonrental activity.

5) The taxpayer customarily makes the property available during defined business hours for nonexclusive use by various customers.

6) The property is provided for use in an activity conducted by a partnership, S corporation, or joint venture in which the taxpayer owns an interest.

** Trade or Business for §469 Purposes

An activity is a trade or business if it involves the conduct of a trade or business under §162 or is an endeavor conducted in anticipation of becoming a trade or business. A trade or business activity is only a passive activity if the taxpayer does not materially participate in the activity.

*** Material Participation

In recent years, there have been a few cases involving taxpayers who rented out residences for an average period of customer use that did not exceed seven days. Thus, the activities were not rental activities. The court treated the rentals as trade or business activities that then made material participation a relevant issue. In these cases (see one summarized next), the court did not find that the taxpayer devoted sufficient work to the activity to satisfy one of the material participation tests (§1.469-5T). Thus, the losses generated in the activity were passive activity losses.

Chapin v. Comm'r., T.C. Memo 1996-56—Taxpayer rented out a beach condo for rental periods of seven days or less (thus, not a rental activity). A rental agent handled advertising, rentals, fielding phone calls, cleaning and repairs. Taxpayers alleged that they spent over 170 hours during the nonrental season to maintain the condo. The work consisted of painting, cleaning, shopping, general maintenance, and driving time to the condo. No log was kept of their activities, but they did have some receipts. The Service disallowed the deduction of the losses on the basis that the taxpayer did not materially participate (MP) in the activity. Taxpayers argued that they met the substantially all MP test or the over 100 hours and no one else does more test, or the facts and circumstances test. The court agreed with the Service that these tests were not satisfied because the rental agent did the bulk of the work that would be regular, continuous and substantial and there was no evidence to show that the taxpayer spent more time in the activity than the rental agent. In addition to satisfying the time requirements of the safe harbor MP tests, the court stated: "Measuring participation in terms of time may be useful in setting minimum requirements and in defining safe harbors, but the deductibility of a loss under section 469(h)(1) depends also on regular and continuous participation in the activity."

Note: There was no discussion as to whether or not the activity was a trade or business activity; the court stated that a nonrental activity is passive if the taxpayer does not MP. However, per the Code, when an activity is not a rental activity, it can only be a passive activity if it is a trade or business in which the taxpayer does not MP. Theoretically, if the activity is not viewed as a trade or business, the loss limitations of §469 would not apply, but the limitations of §183 or §212 might apply instead. These alternative limitation provisions are not optimal because expenses are limited to the 2% of AGI rule of §67 (see flowchart).

Similarly, see *Barniskis v. Commissioner*, T.C. Memo 1999-258 and *Oberle v. Commissioner*, T.C. Memo 1998-156.

Interaction of §469 and §280A(e): "If the activity is a rental activity and there is some personal use of the residence during the year, Sec. 280A(e) appears to apply in allocating expenses between rental and personal use. However, if a rental exception is met, but the activity is a trade or business in which the owner does not materially participate, Sec. 280A(e) may not apply as there are no "expenses attributable to rental." (The temporary regulations for Sec. 469 do not provide that the rental definition and exceptions apply only for purposes of Sec. 469.) Sec. 262 would still disallow any personal expenses not otherwise allowable under the Code, but they could be calculated other than by applying the Sec. 280A(e) allocation formula."[13]

Tax Planning Considerations Under §280A and §469

- If a loss is being generated and carried forward, consider whether the rent can be raised to avoid generating losses that will be postponed.
- Consider debt restructuring if doing so will avoid the generation of losses, or for a §469 rental, will allow for generation of passive activity income to offset other PALs. An individual might have a principal residence with equity and be able to obtain a home equity loan to pay down the debt on the rental dwelling. Of course, consideration must be given to potential AMT consequences of home equity debt and the concerns of placing too much debt on a personal residence.
- If the use of a residence test is met, such that the §280A(c)(5) limitations apply, consider reducing the number of personal use days to instead cause the limitations of §469 to apply. One advantage of the §469 limitation over that of §280(c)(5) is that PALs may be used against passive activity income from other activities while a loss carried forward under §280(c)(5) is only usable against future income of the dwelling from which the loss arose. Also, for individuals with AGI under $150,000 who actively participate in the rental activity, up to $25,000 of a PAL from a rental real estate activity may be applied against non-passive activity income (the $25,000 amount phases out for individuals with AGI exceeding $100,000; see §469(i)). If the rental of the dwelling is a passive activity and generates net income and the owner has PALs from other activities, the PALs offset the PAI. In addition, if the rental falls under §469, sale at a gain may generate sufficient PAI to offset suspended PALs of the owner. Of course, 469 gain recharacterization rules must be considered (Reg. §1.469-2(c)(2) and §1.469-2T(c)(2)), along with potential advantages of converting the dwelling to a principal residence and applying the gain exclusion of §121 to the gain. One additional caution of converting a dwelling from the §280A to the §469 limitations is that any interest expense attributable to personal use will no longer be deductible under §163(h) and §262 (because the dwelling no longer meets the use as a residence test). However, since the personal use would be minimal, this may not be a major concern of the owner.

Shared Ownership of a Residence—All Owners Reside in the Residence

If the residence is encumbered, and the owners are jointly liable on the debt, each should classify the debt under the rules of §163(h). Both §163(h)(3) and its legislative history (RA'87) refer to acquisition and home equity indebtedness with respect to any qualified residence of the taxpayer. Thus, the limitations appear to be per the residence of each owner, rather than capped per house. Also, §163(h) is one of those provisions that applies the same limits to both single and married (MFJ) taxpayers. Thus, it appears that if two separate individuals (not MFS) own a residence together that qualifies as the principal or second residence of each, each may deduct interest on up to $1 million of acquisition debt and $100,000 of home equity debt.

[13] "Rental of Residences," page 544, *supra*.

Rulings under old §121 held that the exclusion benefits were available to joint owners of property even if not married. See Rev. Rul. 67-234, 1967-2 C.B. 78, Rev. Rul. 67-235, 1967-2 C.B. 79, and PLR 8942008.

Guidance on the application of §163(h)(3) and §121 for co-ownership situations would be helpful.

Shared Ownership of a Residence—Only One Owner Resides in the Residence

I. Overview

For various reasons, an individual seeking to purchase a residence may not be able to do so without obtaining funds from another person. For example, a person may not have a sufficient down payment to obtain a mortgage of sufficient size to purchase a home. Possible solutions for the individual seeking home ownership include:

1) Borrow the downpayment. (Unlike other topics covered in this outline, this one does not involve taxpayer's ownership of a residence. However, it is covered here because of the potential for certain arrangements to be viewed as an equity interest and because it is an alternative to the equity share arrangement that is also covered in this outline.)

2) Find a co-owner seeking potential benefit from appreciation on the home as well as current tax deductions, but who will not occupy it (equity share arrangement).

3) A co-ownership arrangement that does not meet the IRC shared equity financing arrangement under §280A(d)(3).

II. Borrowing the Downpayment

A. Concerns & Solutions

1. If Occupant borrows too much of the downpayment, he might not qualify for the primary loan on the property.

   a. Solution:

      - Occupant should pay down all other debts

      - Occupant should wait until he has a larger share of the downpayment

      - Borrow from a relative or employer

2. Will interest paid on the loan from Investor be *qualified residence interest* to Occupant?

   a. Qualified residence interest (QRI):

      • IRC §163(h)(3) & (4) and Reg. 1.163-10T

      • QRI is interest paid or accrued during the tax year on acquisition indebtedness (AI) or home equity indebtedness (HEI) with respect to and secured by a qualified residence, such as a principal residence

      • Reg. 1.163-10T(o) - secured debt is debt on the security of a mortgage, trust deed or land contract where the qualified residence is specific security for the payment of the debt, where the residence could be subjected to satisfaction of the debt, and that is recorded, where permitted, or otherwise perfected per state law

b. Solution:

- Occupant must be sure that written debt instrument states that his principal residence serves as security for the debt and that the instrument is properly and timely recorded (assuming that is how debt is perfected under state law). Otherwise, the interest on the debt will be non-deductible personal interest expense.

3. What is the *minimum* rate of interest that can be charged by the Investor?

This question assumes that the Investor (lender) is a relative or the Occupant's employer and wants to charge a minimum rate of interest and avoid imputing interest under §7872. It is assumed that the loan would meet one of the below-market loan categories of §7872(c)(1).

a. Solution:

- *Imputed interest* (§7872(b)) and *foregone interest* (§7872(a)(1) and §7872(e)(2)) can be avoided by proper structuring of the interest rate. The proper rate depends on whether the debt is a *demand loan* or a *term loan*:

  - Demand loan (§7872(f)(5) & Prop. Reg. §1.7872-10(a)) - payable in full at any time on demand of the lender. Also includes a term loan conditioned on future performance of substantial services by an individual (such as an employer-employee loan); however, for purposes of testing whether such a loan is a below-market loan, it is treated as a term loan (Prop. Reg. §1.7872-3(b)(4)).

  - Term loan (§7872(f)(6) & Prop. Reg. §1.7872-10(a)(2)) - loan that is not a demand loan.

- Demand Loan - to avoid having to calculate foregone interest, interest rate should equal or exceed the short-term AFR at date of issuance and each subsequent semi-annual period. Debt instrument may be structured to automatically adjust the rate to be at least equal to the short-term AFR in effect each January 1 and July 1 (§7872(e)(1)(A) and Prop. Reg. §1.7872-3(c)(2) and §1.7872-3(e)(2)(i)).

- Term Loan - to avoid having to calculate OID, interest rate at date of issuance should equal or exceed appropriate AFR (short-term, mid-term or long-term) based on term of the debt (§1274(d) rules) (§7872(e)(1)(B)). If the parties expect interest rates to go up, they may want to use a term loan to lock in a "low" interest rate.

- OID - OID may still exist under §1273 even though interest at least equal to the AFR is charged. A typical example would be where interest is not payable at least annually. Although the OID rules generally require both parties to report interest income and expense on the accrual method, an exception exists at §1275(b) where the debt instrument was incurred in connection with the acquisition or carrying of personal use property such as a principal residence. Thus, even if OID exists under the rules at §1273, the Occupant/borrower could not deduct any interest until it is actually paid. Special rules exist at §1274A for seller-financing.

4. What is the *maximum* rate of interest that can be charged by the Investor?

The Investor may want to charge a high rate justified by the fact that the debt is the subordinate debt on the property. Or, the Investor may want to charge a rate equal to or less than that charged on the primary debt and include an equity kicker on the debt.

a. Concerns:

i. The Investor might be viewed as having an equity interest in the principal residence, rather than merely being a lender. This could have adverse tax consequences for the Occupant in that payments of "interest" by the Occupant would really be viewed as payments of rent and would not be deductible. If viewed as an equity owner, the Investor likely should have treated each year's transactions as the equity share Investor would have (discussed later).

ii. Usury laws.

b. Applicable Law:

i. Debt versus Equity - Courts have traditionally applied certain criteria or factors to an investment to determine its true nature. The following factors are typically applied to determine the economic reality of the investment as being either equity or debt:[14]

- the intent of the parties
- the debt holder's participation in management
- the borrower's ability to obtain funds from other sources
- the risk level involved
- the formality (or lack thereof) of the arrangement
- the relative position of the holder to other creditors
- existence of a fixed rate of interest
- whether a contingency exists as to repayment
- existence of a fixed maturity date
- existence of any right to enforce repayment

ii. Rev. Rul. 76-413 (1976-2 CB 213) - "The method of computation does not control a payment's characterization as interest, so long as the amount in question is an ascertainable sum contracted for the use of borrowed money."

iii. Rev. Rul. 83-51 (1983-1 CB 48) - Shared Appreciation Mortgages (SAM) - the Service held that interest charged on a mortgage to buy a principal residence was interest under §163. The interest charged was in two parts: a fixed rate of interest and a contingent amount equal to 40% of the appreciation. The SAM agreement also provided that the borrower would occupy the property; that only a debtor-creditor arrangement existed; borrower was responsible for property taxes and other costs of ownership; borrower had the right to sell, transfer or improve the property without the consent of the lender; and the lender was not liable for any decrease in the value of the property. The Service ruled that to be deductible, interest did not have to be charged at a fixed stated rate. The only requirement was that the interest be an amount "definitely ascertainable" pursuant to an agreement between the borrower and lender. Because the SAM in the Ruling included a method to compute the contingent interest, it was ascertainable and thus interest for §163 purposes.

3. Solution:

To be sure that the investment is "debt," the parties should:

• be sure that the documentation:

- calls the transaction a loan
- specifies repayment terms

[14] *Fin Hay Realty*, 398 F.2d 694, 68-2 USTC ¶9438, 22 AFTR2d 5004 (3rd Cir. 1968); *Estate of Mixon*, 464 F.2d 394, 72-2 USTC ¶9537, 30 AFTR2d 5094 (5th Cir. 1972).

- provides a maturity date
- specifies procedures in case of borrower default

• provides for the payment of some interest at a fixed rate (if all of the interest is contingent, the investment will look more like an equity investment)

• provide only "typical" rights of the lender such as approval of insurance on the secured property, resell terms, etc.; general management rights should not be provided for

• the computation and timing of the payment of the contingent element of the interest should be clearly spelled out in the loan document, as was done in Rev. Rul. 83-51

• the Investor/lender is not on the title to the property

• the mortgage is properly recorded

B. Benefits and Drawbacks to the Occupant

1. Benefits:

a. points and other borrowing costs likely avoided

b. avoid potential hassles of having a co-owner of the property

c. all payments (except principal) to Investor are deductible interest assuming the requirements of §163(h) are met

2. Drawbacks:

a. overall interest rate higher than if had no second mortgage

C. Benefits and Drawbacks to the Investor

1. Benefits:

a. likely to generate a higher rate of return relative to other investments

b. less administrative work than with the equity-share arrangement

c. ability to help a relative acquire a home

2. Drawbacks:

a. risk of borrower defaulting; foreclosure costs and hassles

b. equity-kicker on the debt runs risk of being considered an equity interest; should be able to prevent this through proper structuring

III. Equity Sharing Arrangements under IRC §280A(d)(3)[15]

A. Primary Example

Individual wants to buy a home to be his principal residence (per IRC §121), but while he can afford monthly payments on a loan, he does not have enough funds yet for the entire downpayment.

Who might the owner and investor be?

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[15] Excerpted from outline prepared for a presentation to the ABA Tax Section on May 20, 1995 by Annette Nellen, Terence Cuff, Allen Littman, and Bruce McKechnie.

1) Parents invest in the principal residence of their child to assist the child in acquiring the residence because while the child can afford monthly payments, he or she does not have enough for a downpayment.

2) Employer wants to assist employee in acquiring a principal residence because the employer is in a city where homes are very expensive and the employee does not want to move to the city unless he or she will be able to buy a suitable home.

3) Husband and Wife divorce and Wife is to live in the principal residence with their young children. To eliminate co-ownership of the residence after the divorce, a relative of Wife buys the Husband's interest.

B. Terminology Used in This Outline

Investor: Person providing the additional funds to enable the Occupant to acquire the residence. Possible investors include a relative, employer, unrelated third party, or the seller of the residence.

Occupant: Person who will live in the residence, making it their principal residence.

C. Equity-Share Arrangement - Concerns & Solutions

1. Common fact pattern: Investor provides the $45,000 downpayment for the acquisition of a home costing $300,000 to be co-owned 50% by each and occupied by Occupant. The parties borrow the balance of the funds and are jointly and severally liable on the debt. The Investor and Occupant enter an agreement for the Investor to be repaid by the Occupant buying the Investor's interest at a certain date at market value, or by selling the property at a certain date. Upon sale, Investor's $45,000 investment will be returned to him and Occupant and Investor will equally split any gain. Occupant will pay monthly rent to Investor.

2. Applicable Law:

a. §280A(d)(3) - §280A generally limits deductions with respect to dwelling units used as a residence during the tax year. The provision at §280A relevant to Investor is the rule at §280A(d) that if personal use of a dwelling during a tax year exceeds the greater of 14 days or 10% of the fair rental days, the Investor will be treated as using the unit as a residence and the deduction limitation at §280A(c)(5) will apply. Personal use includes any use by the owner or a co-owner, use by a family member (even if fair rent is paid), and use at less than fair rent.

A special rule at §280A(d)(3) provides that the owner is not treated as having personal use of the unit if it is rented to a person for use as a principal residence. If the unit is rented to a co-owner (Occupant), the Investor can only avoid having such use treated as personal use by the Investor if,

i) the co-owner's use of the unit is pursuant to a *shared equity financing agreement* (SEFA),

ii) *fair rent* is charged, and

iii) the co-owner uses the unit as a principal residence.

b. §469 versus §280A(c)(5): If the SEFA requirements are met, the rental income and expenses of the Investor with respect to the property are not subject to the limitations of §280A(c)(5). Prior to the addition of the passive activity loss limitation rules at §469, the Investor would have been able to deduct any loss generated on the investment. However, even though the §280A(c)(5) limitations might not apply to the Investor, because a rental is involved, the loss limitation rules of §469 will apply, assuming the Investor is a type of taxpayer subject to §469 (individual, estate, trust, personal service corporation or closely-held corporation). §469(j)(8) and (10).

c. §280A(c)(3) Terminology:

i. SEFA

- §280A(d)(3)(C) and Prop. 1.280A-1(e)(3)(ii) & (v)
- must be in writing
- two or more persons acquire a *qualified ownership interest* in a dwelling unit
- one of the owners is entitled to occupy the unit for use as a principal residence and is required to pay rent to one or more co-owners
- may exist even if one or more owners does not charge the Occupant fair rent; but the special rule only applies to the owners that do charge fair rent.

ii. Qualified ownership interest

- §280A(c)(3)(D) and Prop. 1.280A-1(e)(3)(iv)
- an undivided interest for more than 50 years in the entire dwelling unit and appurtenant land that is acquired in the transaction to which the SEFA relates

  Query: what does the "more than 50 years" language imply? In PLR 8410038 (12/5/83), Occupant was to refund Investor's downpayment plus 50% of the equity at the end of 5 years. The ruling did not mention that this provision caused a problem with the "qualified ownership interest" provision.

iii. Fair rental

- §280A(d)(3)(B)(ii) and Prop. 1.280A-1(e)(3)(iii)
- to be determined in light of all the facts and circumstances in existence when the agreement is entered into, including the Occupant's ownership interest
- must look at the "totality of rights and obligations of all parties under the agreement"
- *Fine v U.S.*, 647 F.2d 763, 81-1 USTC ¶9408, 47 AFTR2d 1478 (7th Cir) - the District Court interpreted "fair rental" as an amount that would be sufficient to provide a taxable profit to the taxpayer. The 7th Circuit disagreed with that interpretation because it did not appear to be the definition Congress intended. The Court stated that a facts and circumstances approach must be applied.
- *Bindseil*, T.C. Memo 1983-411 - in determining whether a residence was rented at fair rental to the owner's parents, the Court allowed 80% of market rent to be considered fair rental because a management fee was avoided and the tenants were trustworthy.

3. Comments

a. Guaranteed return to Investor - this should be avoided because it could cause the transaction to be viewed as a loan rather than as an equity-share arrangement. In addition, a guarantee is inconsistent with true ownership of undivided interests.

b. Documentation - all pertinent terms of the arrangement should be in writing: ownership percentages; ownership form (tenants in common, etc.); that it will be used as the Occupant's principal residence; rental charge; who is responsible for paying particular expenses; duration of the agreement; what happens if either party fails to pay expenditures; what happens if one of the owners dies, becomes bankrupt or is divorced; payment of special assessments; etc.

c. Rental charge - case law may support rental at 80% of market rent because the Occupant has an ownership interest in the property and is likely to take better care of the property. Also, no management fee is charged. However, note that the case law cited earlier did not involve co-owners of property. To satisfy the definition of a SEFA, the Occupant should make rent payments to the Investor.

d. Interest expense - The arrangement will likely be structured such that each party pays their share of principal and interest. If the parties are liable jointly and severally and the Occupant instead pays all of the interest expense, he can view it as his interest expense (Rev. Rul. 71-268 (1971-1 CB 58), Rev. Rul. 71-179 (1971-1 CB 58), *Neracher*, 32 BTA 236 (1935)). However, payment by the Occupant of the Investor's share of interest expense will likely not be viewed as QRI because the Occupant does not own the entire interest in the residence. For additional concerns on unequal splitting of expenses, see the discussion below on "fair rent" and "right of reimbursement."

e. Property tax expense - assuming both owners are jointly and severally liable for the taxes, payment by either of any percentage of the tax should entitle the payor to deduct the amount paid (*Nicodemus*, 26 BTA 125 (1932)). But, see discussion below on "fair rent" and "right of reimbursement."

f. Depreciation - only the Investor is entitled to take depreciation on the residence (it is personal use property to the Occupant). The amount is based on the Investor's ownership percentage. Query: If a family member is the Occupant, will the Investor be allowed to depreciate his interest in the property?

g. Other expenses such as insurance, homeowners' fees, maintenance, etc. - payment by the Occupant will result in no tax deduction (§262), while payment by the Investor should yield a deduction (§162 and §469). The amount of deductions of these items that each owner is entitled to depends on several factors, including, who was obligated to make the payment per the agreement between the parties, which party made the payment, whether a right of reimbursement exists between the parties, whether the expenditure is a non-deductible personal expenditure, and the application of §469 to the Investor.

h. Unequal splitting of expenses - it is not clear in the tax law whether payment of expenses by one co-owner of more than his ownership share would entitle him to a deduction for the entire amount. It is also unclear whether payment of deductible items by the Occupant and items that would be non-deductible by the Occupant, but deductible by the Investor (such as insurance), will be respected. Possibly, the Service could take a substance over form argument to state that each owner is deemed to have paid his or her proportionate share of each expenditure, similar to a §482 approach.

"Fair rent:" Where the Occupant is not paying his fair share of expenses (either paying too much or too little), the validity of the §280(d)(3) arrangement will be a concern because the economics of the situation may indicate that "fair rent" is not being charged.

One co-owner's payment of more than his share of expenses could be viewed as income to the other. For the Investor, such income would be viewed as additional rental income (but may also result in a corresponding deduction); §1.162-11(a) and §1.61-8(c). For example, in *Blunt v. Comm'r.* (25 TCM 1445; T.C. Memo 1966-280), property taxes paid by a 50% owner for 100% of the commonly-owned property was viewed as 50% property tax and 50% rent to the other party (payor occupied the entire property for business purposes under an agreement that he would pay 100% of expenses). The payor was able to treat payment of the co-owner's share of property taxes as rent expense. Also relevant to determining each party's share of expenditures is whether the payor is viewed as having a right of reimbursement from the other party (discussed next).

Right of reimbursement: "It is well settled that expenses for which there exists a right of reimbursement are not ordinary and necessary business expenses within the meaning of [§162]." *Levy v. Comm'r.*, 212 F.2d 552; 54-1 USTC ¶9377; 45 AFTR 1474 (5th Cir.) citing: *Glendinning, McLeish & Co. v. Comm'r.*, 24 BTA 518 (1931), aff'd, 61 F.2d 950, 1932 CCH ¶9565, 11 AFTR 1025 (2d Cir.); *All Russian Textile Syndicate v. Comm'r.*, 62 F.2d 614 (2d Cir.); *Universal Oil Products v. Campbell*, 181 F.2d 451 (7th Cir.). Where a right of reimbursement exists, payment of an expenditure in full by the payor is viewed as a loan or advance to the other party and not the payor's expenditure. The possibility of the payor receiving reimbursement from the other party must be a fixed right with no substantial contingencies. If there is uncertainty about reimbursement or there is no existing legal right to the reimbursement, the expenditure should not be viewed as an advance and should instead be deductible by the payor (assuming it is otherwise deductible). *Alleghany Corp.*, 28 T.C. 298, 305 (1957); TAM 7506309970A (6/30/75); *The Electric Tachometer Corp.*, 37 T.C. 158 (1961), acq. 1962-2 C.B. 4. Where a right of reimbursement exists, but the payor is never reimbursed, the other party may end up with cancellation of debt income when the statute of limitations runs on the right for reimbursement and the payor has a bad debt which may be deductible.

In *Estate of Boyd v. Comm'r.*, 28 T.C. 564 (1957), one co-owner paid more than his share of a repair. The Court stated:

> It is a fundamental rule of property law that co-owners share necessary expenses of the repair of the common property in proportion to their ownership. A tenant in common, who makes necessary repairs on the common property, is entitled to reimbursement from other co-tenants. ...There might be doubt that the expense, in excess of one-half, when paid by the owner of a one-half interest would be "ordinary" -- on the theory that it is like paying the obligation of another. ... The deduction under section 23(a)(2) as here applicable is for "expenses paid * * * during the taxable year for the * * * maintenance of property held for the production of income." This obviously means for the production of the taxpayer's income. In *Frederic A. Seidler*, 18 T. C. 256, 260, we held the above statute "contemplates situations where the property is so held for the production of income for the taxpayer himself." Here the taxpayer reported rental income as 50 per cent of the total. There must be a connection between the property interests upon which the division of the entire rental income is based and the amount of deductible expenses by the owners of the property interests. In *Trust of Bingham v. Commissioner*, *supra*, it is held (at p.370):
>
> > The requirement of §23(a)(2) that deductible expenses be "ordinary and necessary" implies that they must be reasonable in amount and must bear a reasonable and proximate relation to the management of property held for the production of income. * * *
>
> Each co-tenant owned separate property interests in the common property that produced separate income to each, and the separate expenses that are deductible by each is that portion of the entire expense which each separate interest bears to the whole, and no more.
>
> Petitioner makes much of the fact that there was no agreement between the co-tenants for reimbursement. The fact is immaterial. The point is the right to reimbursement existed -- and we do not understand petitioner to argue it did not -- and it is of no consequence whether the right to reimbursement arose by contract or a legal relationship as to the common property.

Thus, for example, if the Occupant has no obligation to reimburse the Investor for insurance premiums, and the Investor specifically foregoes any right of reimbursement from the Occupant for that expenditure, the rules on right of reimbursement should not prevent the Investor from deducting 100% of certain expenditures it pays alone. However, other tax issues noted in this outline (such as §482 and whether "fair rent" is being charged), must also be considered before either party pays more than his share of an expenditure and before he deducts an expenditure for which he paid 100%.

i. §469 - as discussed earlier, in an equity-sharing arrangement, the Investor has a rental activity that is subject to the passive activity loss limitation rules. If the Investor has AGI under $150,000 and the rental will produce a loss, the Investor will want to meet the active participation standard at §469(i), the $25,000 offset rule. To meet that standard the Investor must be involved in some management of the property. It is also a good idea for the management responsibilities of the Investor to be stated in the rental agreement. See §469(i) and the Blue Book, TRA '86, page 244 - 245 for the definition of "active participation." If the rental will generate income and the Investor has other rentals under §469(i) and wants to maximize use of the $25,000 offset, the Investor may want to structure the arrangement so that he has no management involvement and is not an active participant.

Query: Is the level of management required of an Investor in a typical equity share arrangement sufficient to establish active participation? If not and the rental produces a loss, it will be subject to the general passive activity loss limitation rules.

If the requirements of §280A(d)(3) are not satisfied, the Investor will likely meet the "use as a residence" requirement at §280A(d) and the deduction limitation of §280A(c)(5) will apply, which is generally stricter than the §469 deduction limitation.

j. Condominiums - §280A(d)(3) requires that the owners acquire a "qualified ownership interest" in a dwelling unit. Such an interest requires an undivided interest for more than 50 years in the entire dwelling unit and appurtenant land that is acquired. Query: Does ownership of a condominium pose any problems with satisfying the "qualified ownership interest?"

D. Benefits and Drawbacks to the Occupant

1. Benefits:

   a. over long-term, might be less expensive than debt

   b. payment deferred until property disposed of or Occupant buys out Investor

2. Drawbacks:

   a. must make payments of non-deductible rent to the Investor

   b. inability to make decisions on own with respect to the property

E. Benefits and Drawbacks to the Investor

1. Benefits:

   a. may be a method for generating passive activity income

   b. if loss is generated, might be a tax shelter if Investor's AGI is less than $150,000 and meets the active participation standard at §469(i)

   c. may generate a higher rate of return relative to other investment alternatives

   d. ability to help a relative acquire a home

   e. production of §1231 capital gain + rent rather than all interest income if instead loaned money to Occupant

2. Drawbacks:

   a. risk that the residence might decrease in value over the term of the equity-share arrangement

   b. more administrative work involved than with debt

   c. if Occupant stops making rent payments, problems exist because unlikely to be able to foreclose when Occupant only owes rent to Investor

   d. If SEFA is not valid (such as because rent is not charged), then use of residence is personal use to the Investor and if he or she already has two homes, the interest would not be deductible

IV. Equity Sharing Arrangements Not Falling Under IRC §280A(d)(3)

If the owners of the property do not use a SEFA, the treatment of interest and the applicability of §121 and §280A will depend on how each owner’s ownership interest is classified. If the arrangement is not a SEFA because fair rent is not being charged, it may be that the absent owner is providing a gift of rent to the occupant-owner. The facts and circumstances of the particular arrangement should be examined to determine the tax consequences for both owners.

Summary of Some Cautions

I. Primary authority details

The rules applicable to residential property, whether owned for personal use or rental, are quite detailed and sometimes intertwined (for example, see the earlier flowchart). Thus, it is important to read the statute, legislative histories, regulations and rulings carefully and to be aware that not all fact patterns are addressed by such guidance.

II. Limitations

Just about every provision applicable to ownership of residential property has some type of limitation: §121, §280A, and §469, among others. The existence of these limitations warrants careful consideration in all tax planning decisions of individual taxpayers.

III. Conversions

With the removal of the once-in-a-lifetime limitation in §121, individuals with multiple residences may want to consider converting vacation and rental homes into principal residences prior to sale. The timing limits of §121 and suspended PAL rule of §469(g) and the §280A(c)(5) loss carryforward rule should be considerations in these fact patterns. Some individuals may convert principal residences to rentals for up to three years prior to sale to obtain income from the property prior to sale. Basis limitations on the conversion (§165 and §167) should be considered. Also, conversions may have property tax consequences, such as due to loss of a homeowner's exemption.

IV. Form of ownership

The tax provisions discussed in this outline vary as to who they apply to. Also, there have been rulings over the years under old §1034 and §121 when a principal residence is owned by a trust. Guidance has been issued with respect to the application of new §121 by a bankruptcy estate. In Chief Counsel Notice N(35)000-162 (8/99), the Service agrees that a bankruptcy estate may use the §121 exclusion.

For guidance regarding trusts, see §671 to §677, Rev. Rul. 66-159 (1966-1 C.B. 162), Rev. Rul. 85-45 (1985-1 C.B. 183), and PLRs 8239055, 9118017, 199912026 and 200018021. PLR 199912026 states: "Rev. Rul. 85-45, 1985-1 C.B. 183, considers whether gain realized from the sale of trust property used by a beneficiary of a trust as the beneficiary's residence qualifies for the one-time exclusion of gain from the sale of a residence under section 121 of the Code. The ruling holds that because the beneficiary is treated as the owner of the entire trust under sections 678 and 671 of the Code, the sale by the trust will be treated for federal income tax purposes as if made by the beneficiary. The reasoning of Rev. Rul. 85-45 is still valid even though section 121 has been substantially amended. In the present case, because Taxpayer will be considered the owner of the entire Trust (including the Residence) under sections 676(a) and 671, Taxpayer will be treated as the owner of the Residence for purposes of satisfying the ownership requirements of section 121 of the Code."

In PLR 200004022, the Service ruled that a home or which title was transferred to a partnership qualified under §121 because the residence served no business purpose of the partnership.