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Buying, Owning, and Disposing of Real Estate

by Barry Leibowicz

Your clients' home can be their biggest tax headache if you don't give them enough guidance.

- Here are some things to do:

- ☐ When your clients are planning to take on a mortgage, review the mortgage deduction provisions of the Tax Code;
- ☐ Your clients can deduct interest paid on a mortgage covering a qualified residence. What amounts to a "qualified residence" is a matter to discuss with them;
- ☐ The maximum amount of mortgage debt that your clients can deduct interest on is limited to $1 million. Your clients' marital status can change how this deduction is taken;
- ☐ First-time home buyers who plan to tap the "mom bank" for down payment money should know about the ways to do it: gifts, private mortgages, and small below-market loans;
- ☐ Vacation homes present fertile soil for tax puzzles. Your main inquiry should be finding out how your clients use the property. Under some circumstances, your clients can take deductions for expenses;
- ☐ The one-time $125,000 exclusion must be used judiciously. If it's used once, even if not to the full $125,000 extent, it's no longer available to your clients; and
- ☐ Encourage your clients to consult an accountant and to speak to you before making any major move.

For explanatory text see page 19.

Buying, Owning, and Disposing of Real Estate

by Barry Leibowicz

Make sure the Great American Dream doesn't turn into a tax nightmare.

THERE ARE FEW transactions more common than the purchase or sale of a residence. It is also one of the few times when your clients are happy to see you. Accordingly, most of us seek out and prize these transactions as a simple, basic, and rewarding part of practice. Many of us handle these

A "residence" need not be a residence in the traditional sense and the definition encompasses not only individual homes, but cooperatives, condominiums, motor homes, and boats.

transactions by rote. Therein lies the danger. Acquiring, owning, and selling a residence has multiple tax effects, particularly since the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 ("TRA '86"). The homeowner's decisions during these transactions, often made without conscious analysis by the attorney, will have long-term, lasting, and possibly significant tax effects. It is therefore appropriate when your client is considering a purchase, sale, or ownership of a residence that you step back from the mechanics of the transaction, and consider how your choices, or the choices you must suggest, will affect the client's tax liabilities.

THE MORTGAGE DEDUCTION • After the TRA '86 most deductions for interest on indebtedness disappeared. One of the few interest deductions left was for home mortgage interest—one of the major incentives to home ownership. *See* Internal Revenue Code ("Code") §163(h)(2)(D). (All section references are to the Code unless noted otherwise.) The TRA '86 does, however, contain new restrictions and limitations. Anyone contemplating the purchase of a home must be familiar with these restrictions to clearly determine the cost of the undertaking.

Qualified Residence

Only qualified residence interest is deductible. Qualified residence interest is interest paid or accrued during the tax year on indebtedness secured by property which is a qualified residence of the taxpayer. §163(h)(3). A qualified residence of the taxpayer is the taxpayer's principal, and one other, residence. §163(h)(4).

Multiple Residences

If a taxpayer has multiple secondary residences, she can decide which residence to consider the qualified residence each year, and the choice can differ from year to year depending on circumstances. §163(h)(4)(A). It appears possible to have a qualifying secondary residence even without a primary residence. A "principal residence" is simply one that meets the definition of a principal residence for purposes of rolling over gain on section 1034 sales. §163(h)(4)(A)(i). Thus, the taxpayer who rents an apartment in the city and owns separate summer and winter vacation residences would be limited to a mort-

gage interest deduction on only one of the two houses since neither is a principal residence.

A "residence" need not be a residence in the traditional sense and the definition encompasses not only individual homes, but cooperatives, condominiums, motor homes, and boats. A large boat that a taxpayer lives on during his vacations could be his personal vacation home and a qualified residence. *See* Temp. Treas. Reg. §1.163-10T(p). Note that these second residences are more restricted when the taxpayer is subject to the alternative minimum tax ("AMT").

What's Deductible?

Deductible mortgage indebtedness takes two forms: acquisition indebtedness and home equity loans. Acquisition indebtedness is debt incurred to acquire or improve a home. §163(h)-(3)(B). There is a tracing requirement for the funds. Notice 88-74, 1988-2 C.B. 385, allows a 90-day period before or after acquiring a home for incurring acquisition indebtedness. However, in some cases separate transactions that fall outside the 90-day period have been considered part of a single integrated plan for purchasing a home and deemed acquisition indebtedness. *See Huntsman v. Comm.*, 905 F.2d 1182 (8th Cir. 1990). (The Internal Revenue Service has said it will not appeal this decision, but does not agree with it.)

Maximum Deduction

The total mortgage that interest on acquisition indebtedness can be deducted from (other than debt incurred before October 13, 1987) is limited to $1 million. §163(h)(3)(B). Married people filing separate returns are limited to an interest deduction on a $500,000 mortgage. Generally, one spouse may not deduct the interest on the other spouse's property when they file separate returns unless there is qualified residence interest. In that case, if both husband and wife consent to do so in writing, either one may deduct the allowed interest on the principal residence and one other residence. For regular tax purposes, the interest on a home equity loan is also deductible, but the deduction is limited to the interest on $100,000 ($50,000 for married filing separate) or if lower, the fair market value of the residence less the acquisition indebtedness it is subject to. §163(h)-(3)(C). Home equity loan interest is *not* deductible for AMT purposes, however. Buying out a spouse's interest in a home incident to divorce creates acquisition indebtedness. Notice 88-74, supra.

Home Equity Loans

Taking out a home equity loan and using part of the loan for improvements and the other part for other purposes will create acquisition indebtedness to the extent of the portion used for improvement, with the balance subject to the $100,000 home

A very common source of down payment money has been a trip to the "mom bank." Parents often supply young home buyers with some or all of the initial down payment.

equity limitation. Temp. Treas. Reg. §1.163-8T. When the interest exceeds the deductible amounts, it is treated as any other interest, and its deductibility depends on its purpose. For example, if the excess proceeds are used for personal purposes, the interest is not deductible. If used for business purposes, it would be deductible in that business. In fact, if used in its entirety for business purposes, it may actually be beneficial to ignore the fact that the indebtedness is secured by a home mortgage and treat it 100 per cent as business interest.

MORTGAGE POINTS • The typical mortgage transaction requires prepayment of mortgage points. Each point is a charge of one per cent of the amount financed. To qualify as deductible acquisition interest, the mortgage points must be a payment to the lender for the use or forbearance of money. If a payment is for brokerage or other services, even though classified as points, it is not deductible. Rev. Rul. 67-297, 67-2 C.B. 87.

When Is the Deduction Available?

If the points are prepaid interest for the use of money, they would typically be amortized and deducted ratably over the life of the loan. However, a special rule permits the purchaser of a personal residence to deduct the qualifying points in the year they are paid. Rev. Rul. 87-22, 1987-1 C.B. 146. This includes not only points on acquisition indebtedness, but on indebtedness to obtain funds for home improvements. To qualify for this immediate deduction the charge must be a usual business practice in the area, at usual rates. §461(g)(2). Extra points paid to reduce the interest rate on the loan do not qualify for the immediate deduction.

Source

The taxpayer must use his funds to qualify the point payment, and points withheld from the loan must be deducted over the life of the loan. *Schubel v. Commissioner,* 77 T.C. 701 (1981). Points paid to refinance an existing mortgage, or for any purpose other than acquisition or improvement, do not qualify and must be deducted ratably over the life of the loan. Rev. Rul. 87-22, 87-1 C.B. 146. Any unamortized balance paid on early discharge of the debt would be deducted at such time. Any undeducted points as well

as prepayment penalties would be deductible in the year a loan was prematurely terminated. Rev. Rul. 57-198, 1957-1 C.B. 94.

THE "MOM BANK" • One of the biggest hurdles for the typical first-time home buyer is scraping up the cash for a down payment. For the client who doesn't already have a house to sell, there are relatively few places to turn. The honorable old practice of saving up for the down payment has fallen to the ax of unreasonable price inflation. As a result, a very common source of down payment money has been a trip to the "mom bank." Parents often supply young home buyers with some or all of the initial down payment.

Gifts

Although parents sometimes want to make a gift of the entire down payment or part of it, this is not always a good idea. Making such a general gift deprives the parent of a substantial resource. Much less obvious is the fact that should marital discord erupt between the child and her spouse, the down payment gift would amount to marital property in many states and result in a gift to a soon-to-be "ex" son-in-law. Although pre- or post-nuptial agreements can often prevent that from happening, it is a very delicate matter and something that parents and children frequently wish to avoid.

Interest-Free Loans

One excellent way to avoid these problems is for the parents to make an interest-free loan, secured by a mortgage on the children's home. This loan could be in the form of a demand obligation and would likely be "called" only to prevent the house from falling into the hands of the prospective former in-law or some other creditor. This kind of loan provides for substantial flexibility, but does require some care.

Below-Market Loans

When a loan is made at a below-market interest rate, additional interest is generally imputed to the transaction and the transaction is treated as if the borrower paid a market interest rate and the lender gave the difference back to the borrower.

A useful exception applies to loans of $100,000 or less between individuals. Under section 7872, the imputed interest amount cannot exceed the borrower's net investment income for the year and net investment interest up to $1,000 per year is disregarded. Accordingly, if the children pour everything they have into the new house and the parents make the loan to provide the balance, the children have no net investment income for the year, and there would be no imputed interest on the loan. The exception is unavailable if the principal purpose of the loan is tax avoidance, rather than love, affection, or assistance in acquiring the new home (the Service be-

lieves it can tell the difference). If the principal purpose was tax avoidance, the interest would be imputed regardless of net investment income.

Small Below-Market Loans

There is never any interest imputed on total outstanding gift loans of $10,000 or less between individuals unless the $10,000 loan is used to purchase income-producing property. You should be certain to point out to your clients that should the child's fortunes improve, and he acquires investments producing net investment income, there could be a change in the tax picture not only for himself, but his creditor-parents.

Private Mortgages

The down payment loan can also take the form of a regular first or second mortgage, bearing interest. Often, the interest payments can be mutually advantageous. The borrowers can deduct interest paid at a high rate and the lenders can report it at a low tax rate. The parties must, however, be aware of the restrictions on loan transactions between related parties.

Arm's Length

Interest paid on a mortgage between related parties is as deductible by the borrower and includable for the lender as in any other mortgage. But these transactions, being suspect, demand that the parties deal on an arm's length basis. The recipient must scrupulously report the income, since audits of the borrower's return also seek the lender's return.

THE COUNTRY HOME • If a client is purchasing a non-primary home, for vacation or other use, it is important to discuss the client's intended use of the property. Often homes serve vacation and rental functions depending on the time of year. The way the property is treated depends on how much rental activity is associated with the home. §280(A)

If a home is rented for fewer than 15 days in any one year, it is treated as a personal residence. In addition to the principal residence of a taxpayer, one additional personal residence qualifies as a qualified residence for purposes of the home mortgage interest deduction. That "qualified residence" can be selected each year to handle the specific circumstances of multiple secondary homes. All rental income derived from the 14 or fewer days of rental is excluded. As a qualified residence, its mortgage interest and real estate taxes are allowed as itemized deductions. No expenses such as utilities, depreciation, and maintenance are allowed as deductions.

Rental Property Characterization

Things change dramatically if the residence is not maintained for personal use for the greater of 14 days or 10 per cent of the total days rented. The residence is then treated

as a purely rental property and all expenses are allocated between any personal and rental days. This is a mixed blessing, since it can produce a deductible loss, particularly if there are substantial mortgage, real estate tax, depreciation, and maintenance expenses. However, as a nonpersonal loss, this item would be subject to the passive loss limitations. An exception to these passive limitations allows for a limited $25,000 per year deduction against active income. §469(i). However, if the loss exceeds $25,000, or if the taxpayer's adjusted gross income is above $100,000, or the taxpayers are already taking the full $25,000 passive loss exception against other property, the characterization of that property as rental rather than as qualified personal residence may actually be a real problem. The mortgage interest and real estate taxes are fully deductible without regard to any passive loss limitation if the property is a qualified personal residence, and only deductible against passive income and the limited exception amount if it is rental.

Personal Residence Characterization

If the residence is rented for 15 days or more and used for personal purposes for more than 14 days, or more than 10 per cent of the rental days, it has elements of both personal and rental use, and expenses are allowed only to the extent they exceed the net rental income after deductions for home mortgage interest and real estate taxes. The rental income is first reduced by the home mortgage and real estate deductions and if anything is left, it is then reduced by the expenses and depreciation allocable based on days of use. These expenses can produce no loss (see Appendix).

When a client acquires a multifamily home, it is best to think of that home as multiple properties.

MULTI-USE PROPERTY • When a client acquires a multifamily home, it is best to think of that home as multiple properties. You can think of a three-family home, one apartment of which is to be occupied by the taxpayer, as two separate buildings. One building is the taxpayer's principal residence and the other a rental building. The purchase price can be allocated pro rata between those "two buildings" based on the relative size of the units or other appropriate allocation criteria. Thereafter, in determining how to handle the property, you need only think of it as separate properties.

Mortgage Allocation

Suppose we had three units of identical size and quality, one of which was a principal residence and the other two were rented. Assume also

that there was a $300,000 mortgage on the property, that it cost $450,000 and the maintenance and operation of the entire property was $3,000 a year. We therefore have the equivalent of two buildings one of which cost $150,000 and had a mortgage of $100,000 and was purely a principal residence. The other building (the rental unit), had cost $300,000 subject to $200,000 of mortgage and $2,000 per year of maintenance.

Respective Deductions

The mortgage and the real estate taxes attributable to the principal residence portion would be fully deductible assuming it was a principal or a secondary residence and the interest was qualified. There would be no deduction for the maintenance attributable to the personal unit and there would of course be no depreciation. The income from the rental unit would be reported and reduced by the mortgage interest, taxes, maintenance, and depreciation allocable to it. If the property produced a loss, it would be a passive loss and deductible only against passive gains or up to the $25,000 passive loss limits.

Basis

The basis of the rental "building" would be decreasing each year by the depreciation taken, and when the property was sold you would once again have to consider it the sale of two buildings. The principal residence portion would be eligible for the tax-free rollover, and its basis would not have been reduced by any depreciation taken over the years. The rental portion would not qualify for the rollover, and if there was a gain, it would be taxed on sale, regardless of any rollover. Further, the basis of the rental portion of the unit is likely no longer to be proportionate to that of the principal residence, because it has been reduced each year by the depreciation taken. Any passive losses not allowed because of the passive loss limits during the holding of the rental property would have been suspended and could be used to reduce the gain on the sale of the rental portion.

Like-Kind Exchanges

If one is selling a multi-use property, it may be appropriate to integrate its sale with a like-kind exchange, acquiring new rental property for the old. Although the rental portion would not qualify under section 1034 for the rollover sale of a principal residence, it would qualify for like-kind exchange nonrecognition of investment properties under section 1031. A taxpayer going from a multi-use residential property to another multi-use residential property might consider a like-kind exchange, whether direct or three-way, in structuring the transaction.

THE RESIDENCE IN ESTATE PLANNING • A consideration often overlooked in real property acquisition is the effect of title holding. The

choice of title holder can have far-reaching consequences, not only for income tax purposes, but estate tax purposes as well. There is a presumption that jointly held property was owned 100 per cent by the first person to die. Code §2040(a). This presumption can be rebutted by showing the survivor's contribution of consideration for purchasing the property, and that the consideration does not include gifts received from the decedent. When this is proved only the portion that the survivor did not provide would be included in the estate.

Joint Tenancy

A special rule exists under section 2040(b) for a joint tenancy for married people. A tenancy by the entirety results in the inclusion of one-half of the value of the property in the estate of the first to die. That half would not be taxed because of the unlimited marital deduction. However, holding real property in a tenancy by the entirety may not be the best thing to do for tax purposes. The portion of the property that passes through an estate, even when passing tax-free to the surviving spouse, receives a step-up in basis to fair market value on the date of death (or alternate valuation date). §1014. The gain accrued before death is thereby wiped out and escapes income taxation.

It would be better, however, to pass the entire property to the surviving spouse and include the entire value in the estate. If the estate fell below the unified credit amount offset of $600,000 or went to a surviving spouse there would be no estate tax; but the property would step-up in basis to fair market value. The surviving spouse could then sell the property without tax on any of the gain that accrued during the life of the decedent. Of course this should only be done when property is eligible for the marital deduction, the estate will be less than $600,000, or the estate tax rates fall short of the income tax rates on the gain.

Title Changes

If you have a pretty good idea who is going to die first, it may be appropriate to title the property to that individual and avoid any tax on gain accruing from a purchase at his or her death.

GRITs

Some of the home's value can be removed from a large estate through a Grantor Retained Interest Trust ("GRIT"). A principal residence was an exception to the revised rules restricting the benefits of GRITs for other assets. §2036. A nontax consideration would be the effect of the marital distribution law of the particular state, which could make title-holding irrelevant or quite important.

Financing Through Children

Of particular concern is the case in which a residence is to be acquired for an elderly person, a mother or a fa-

> ***Advise your client to develop a starting cost from the real estate closing statement and add all subsequent capital improvements to it.***

ther for example, and the child pays for the purchase and operation of the household. Remember, mortgage interest is only deductible if the taxpayer is liable for the debt or it is secured by his property. If mom buys a house subject to a mortgage and her son pays it, the son can't deduct the interest. Neither can mom. Although the son could make cash gifts to mom, who would then pay the mortgage interest and take the deduction, it is likely that mom is not in a position to fully utilize the deduction.

In this situation it would clearly make sense for the son to buy the home, assume the mortgage, and take the interest deduction. Of course, the son will have to use the home in a manner that would make it a qualified residence. Another advantage of this plan would be to remove the home, its appreciation, and value from the mother's estate, and possibly from inclusion as assets for nursing home care purposes.

Another possibility is for the son to buy and pay for all expenses on the home, and have the mother pay a fair market rent. (It would be a good idea to document the rent as being at fair market rate.) Note that conveying the home from mother to son with the mother retaining a life interest won't work. The life interest in the home would make it includable in the mother's estate. §2036. Although this is preferable in some cases (when the estate is below $600,000 and the property will step up in basis by passing through the estate), in other circumstances it may cause problems by swelling an already substantial estate.

OWNING A RESIDENCE • Generally, owning a residence does not present much of a problem for the attorney. Typically, the professional dealt with during the ownership period is the accountant. However, some aspects of owning and operating a residence should be familiar to the real estate practitioner and conveyed to clients.

You should explain to clients after they purchase the property which expenditures are deductible and which are capitalized. Although mortgage points and real estate taxes are usually deductible, other expenditures are part of the purchase of the property and become part of its cost or adjusted basis for tax purposes. Capitalized expenses include mortgage tax, recording fees, attorneys fees, bank fees, and title fees. In fact, just about any expense incurred in acquiring a residence that is not immediately deductible becomes part of its tax cost.

That tax cost is extremely important in computing gain or loss on subsequent sale.

Capital Improvements

Advise your client to develop a starting cost from the real estate closing statement and add all subsequent capital improvements to it. Capital improvements are expenditures that improve or appreciably extend the property's useful life. They do not include repairs. Since in a principal residence repairs do not provide any tax benefit, the concept of capital expenditure versus repair is extremely important: repairs will never be deductible or reduce gain in the future; capital expenditures will. §1016. An example of capital expenditure would be new siding; repainting would be a repair.

Records

Advise your clients to maintain records of all improvements and expenditures on the home. These records should not just be included with the yearly tax records (which are typically destroyed after seven years), but should also be kept in a "house file" which will be useful when selling the property. On the sale of a principal residence and acquisition of a new one, the tax basis of the new residence is derived from the old. The purchase price and costs of the last three or four houses, or of one over 30 or 40 years, can therefore be relevant in determining the cost of the client's latest home.

Real Estate Taxes

Deductible real estate taxes on a residence do not include special assessments for the construction of local benefits like street, sidewalk, and other similar improvements. Treas. Reg. §1.164-4. However, assessments for local benefits are deductible as a tax if they are made to maintain, repair, or meet interest charges on such benefits. Treas. Reg. §1.164-4(b). If the assessment is used for multiple purposes, the taxpayer has the burden of showing which ones were used for proper maintenance purposes, and in the absence of doing so, none will be deductible. If the house is used for both principal residence and rental purposes, the taxpayer must allocate the taxes between the rental and personal portions. The property would then be treated as two separate properties, one personal and the other business.

TAX-FREE SALE • If a taxpayer sells a principal residence, to the extent the proceeds are used to purchase a new principal residence within two years before to two years after the sale, the gain is not taxed but postponed. §1034. The postponement occurs because the basis of the new house is determined by reference to the basis of the old house. Whether or not property is a principal residence depends on all the facts and circum-

stances in each case. The mere fact that the property has been subjected to a temporary rental is not determinative of whether or not the property is a principal residence. Treas. Reg. §1.1034-1(c)(3)(i). A principal residence can include not only traditional real estate, but cooperatives, condominiums, houseboats, and so forth. The replacement residence must be acquired within a four-year period beginning two years before the sale of the old principal residence and ending two years after. §1034(a). Some special rules apply for members of the armed forces. §1034(h)(2); Treas. Reg. §1.1034(1)(g).

Involuntary Conversion

Under section 1034(a), the taxpayer must treat an involuntary conversion other than condemnation as a sale. In a condemnation he need not do so. Treas. Reg. §1.1034-(1)(h). These tax benefits do not apply to multiple sales within the two-year period, or to a sale of the new residence within the two years following the sale of the old. Replacement periods are suspended for up to four years if the taxpayer has a tax home outside the United States after the sale of the old residence. Code §1034(k).

Rental Use

In the current depressed real estate market, individuals who have had a house that has been purely a principal residence for all the years of ownership may be unable to sell it when they buy a new residence. They are then faced with the prospect of holding it empty or renting until a proper buyer is found, and often opt for the latter. However, this decision could adversely affect their eligibility for tax free rollover of gain on the sale of a principal residence.

Temporary Rental

Whether or not rental use will disqualify a residence from principal residence treatment under section 1034 is a question of fact. A temporary rental primarily for care and maintenance rather than rental income will not change the status from that of principal residence. *See Trisco v. Commissioner,* 29 T.C. 51 (1957), *acq.,* Rev. Rul. 59-72, 1959-1 C.B. 203. A much more recent case held that since market forces made efforts to sell unsuccessful, a temporary rental while sales efforts continued did not change the status of the property from a principal residence. *Bolarus v. Commissioner,* 776 F.2d 1428 (9th Cir. 1985).

Ironically, this may not always be the best determination for the taxpayer. Loss on the sale of a principal residence is not deductible. Since section 1034 does not apply to losses, disposing of a personal principal residence at a loss and acquiring a new one would have extremely negative tax consequences — the accrued loss would never do anyone any good. In these circumstances, it may be appropriate to convert the property to rental or in-

vestment uses which are not temporary. If a sufficient period of time passes after conversion to business—making it clear that the property was not a personal residence—a subsequent sale at a loss would create a tax deduction. However, it must be clear that the rental activity does not fall within the temporary rental case law since temporary rental will not change the nature of the activity from personal. It must be absolutely a permanent rental business.

Fighting the Market

In these troubled times, it becomes even more problematic when the two-year period is about to expire and there is no buyer in sight. Even if the property is rented and it is a temporary rental, if the two-year limitation period passes after the acquisition of the new residence, the taxpayer will lose the benefits of the tax-free rollover. However, an interesting opportunity appears to exist to freeze the gain during the two-year period even if no outside buyer is available. If your client is renting or thinking about renting a principal residence that she can't sell on the market, it might be appropriate for her to sell it during the two-year period to a wholly or partially owned corporation. Although this might seem to suggest self-dealing, the Service apparently approved such a transaction when the acquiring corporation had a bona fide investment intent.

The provision may only be used once in a lifetime and regardless of how much is utilized . . . if the provision were inappropriately used when there was only a $5,000 gain, the entire $125,000 exclusion would be lost.

Priv. Letter Rul. 8946021, published on August 18, 1989, provides that section 1034 applies to bona fide residence sales by husband and wife to a controlled corporation within the two-year limit. The opinion did not say whether a sale to a corporation wholly owned by the husband and wife is a bona fide sale for section 1034 purposes. However, if the sale is at arm's length and the corporation shows a business purpose in its rental activities, it would appear that a bona fide sale may be possible and the section 1034 rollover rescued despite the absence of an outside buyer within the two-year period. Although no one can guarantee whether a particular transaction will be viewed under all the facts and circumstances as a "bona fide sale," one certainly would at least have the argument available, and this beats doing nothing until the

Cohabitation, however, has no effect on the exclusion, unless the parties enter into a common law marriage.

two-year window closes. It seems worth the chance.

THE ONE-TIME EXCLUSION • Taxpayers aged 55 or older need not qualify for section 1034 treatment to avoid tax on some of the gain. Section 121 provides that once in a lifetime a taxpayer may exclude up to $125,000 of gain on a property that was a principal residence in three out of the last five years before the sale. The advantage of this provision over section 1034 is that the gain is excluded, not postponed. It is never taxed. If the gain exceeds the $125,000 limit, and a new property is to be purchased, the two sections can be combined for an exclusion of the first $125,000 of gain and a deferral of the balance. The provision may only be used once in a lifetime and regardless of how much is utilized, no additional amounts are available. For example, if the provision were inappropriately used when there was only a $5,000 gain, the entire $125,000 exclusion would be lost.

December-December Marriages

Of particular interest is how these provisions work when elderly individuals intend to marry. There is only a single $125,000 exclusion per lifetime for one or both members of a married couple. Thus, if either member of a married couple has used the exclusion it is unavailable to the other.

A particularly difficult scenario is presented when an elderly couple, each of whom owns a home, contemplates marriage, and the sale of one or both of their homes before moving to a new joint rental. In that case, a sale after the marriage would be a tax disaster. Only a single $125,000 exclusion would be available to both parties on one of the houses. However, had each sold before the marriage, each could exclude up to $125,000 of the gain. The tax differential between selling first and then marrying, and marrying and selling later, can be as much as $50,000. It is certainly worth waiting while you find a buyer. Cohabitation, however, has no effect on the exclusion, unless the parties enter into a common law marriage.

CONCLUSION • Obviously, you have to discuss quite a few things with your client in the course of any real estate acquisition or sale, and even during ownership. By treating each individual case on its own merits and tailoring the transaction to the needs of the client and the tax law, you can extract the maximum benefit from what is a common, and pleasant, part of your practice.

APPENDIX

A taxpayer has a second home on which he pays home mortgage interest of $10,000 per year, real estate taxes of $3,000 per year, utilities and maintenance expenses of $4,000 per year, and depreciation of $8,000 per year. If the taxpayer rents his home for 10 days a year for $1,500, and uses it for more than 15 days for personal use during the year, it is a personal residence. We can exclude rental income, and assuming it is chosen as the second home for qualified residence purposes, the mortgage interest and real estate taxes totaling $13,000 would be deductible. Taxable income for this taxpayer would decrease by $13,000. The rental income has no effect, nor do the utilities, maintenance, and depreciation.

As an alternative, suppose the taxpayer rented the home for 90 days for total rental income of $4,500, and did not use it for more than 10 per cent of the days rented. It would be a purely rental activity for tax purposes. The $4,500 of rental income would be reported, reduced by all of the mortgage interest, real estate taxes, utilities, and maintenance as well as depreciation. Since those expenditures total $25,000 there would be a net loss from the rental activity of $20,500. If the taxpayer's adjusted gross income was less than $100,000, and he had no other real estate utilizing the $25,000 passive loss exception, that exception would be available to him and allow him to take this entire net loss of $20,500. However if the taxpayer had already used the passive loss exception amount, or the adjusted gross income ("AGI") of the taxpayer exceeded $150,000 maximum, none of this loss would be available as a deduction. (On amounts between $100,000 and $150,000 AGI proportionate corresponding limitations of the benefit occur). If the property was a principal residence only, rather than rental, at least the $13,000 of mortgage interest and real estate taxes would have been deductible. However, if passive income was available, or the loss carry forward was useful, it might be better used as business property. It is always a question of fact in each case.

Of course the part-personal, part-rental situation is more complex. For example, a taxpayer rents her home for 90 days per year and gets $4,500 of rental income, and uses it personally for 90 days as well. In that event, using the approach for interest and taxes of *Bolton v. Commissioner,* 694 F.2d 556 (9th Cir. 1982), the calculation would be as follows:

- Gross rental income: $4,500;
- Rental period taxes and interest: (90/365 × $13,000 = $3,205);
- Income balance of $1,295 to be reduced by rental operating expense and depreciation, but not below zero;
- Minus utilities and maintenance: (90/180 × $12,000 = $6,000);

Of which only $1,295 produces a benefit. Loss of $4,705 and depreciation are both disallowed.

In the part-rental, part-personal situation, expenditures other than otherwise deductible interest and taxes attributable to personal use are not deductible. Interest and taxes attributable to personal use in this case are as follows:

- Mortgage and real estate taxes total $13,000;
- Minus portion allocable to rental use of $3,205;
- Balance which is personal residence interest as itemized deduction = $9,795.

The Act expands the scope of the interest limitation and reduces the amount of the allowable deduction. In general, the expanded limitation now applies to all interest (including consumer interest) except: (a) interest on a mortgage loan on a first or second home; and (b) interest paid in connection with the taxpayer's trade or business. Moreover, the allowable deduction is limited to the taxpayer's net investment income for the year, without the $10,000 exception. The indefinite carry-forward of any disallowed investment interest is continued.

In general, investment interest does not include any interest income or investment interest expense that is taken into account in determining the taxpayer's income and losses from passive activities. The effect of this rule is to require the application of the passive loss limitations before the application of the investment interest limitations.

Interest on indebtedness secured by the taxpayer's principal residence or a second residence continues to be deductible, but only to the extent that the indebtedness does not exceed the amount of the purchase price of the residence plus the cost of any improvements (unless the additional debt is incurred for educational or medical expenses, in which case the debt cannot exceed fair market value). The sum of the purchase price and cost of improvements is deemed to be not less that the outstanding balance on indebtedness incurred on or before August 16, 1976, and secured by the residence on August 16, 1986.

NIXON, HARGRAVE, DEVANS & DOYLE, THE TAX REFORM ACT OF 1986, F-8 (ALI-ABA, Philadelphia, 1986)