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**Hot Topics Relating to Saving Taxes and
Getting Tax Relief and Governmental Incentives
- Federal Income Tax Matters**

**By: Alan J. Tarr
Loeb & Loeb LLP
New York, New York**

**and Richard M. Fijolek
Haynes and Boone, LLP
Dallas, Texas**

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A. 2004 American Jobs Creation Act Changes Affecting Real Estate

1. Depreciation of Leasehold Improvements

- a. General. Leasehold improvements are required to be depreciated in the same manner as the underlying property would be if it were placed in service at the time of the improvement. § 168(i)(6).
 - i. As a result, leasehold improvements to real property are depreciated using the straight-line method over the MACRS recovery period (39 years for nonresidential property and 27½ years for residential property), beginning with the month in which the improvement is placed in service.
 - ii. The rule applies even if the recovery period extends beyond the lease term. In such case, the unamortized portion of the improvement is taken into account upon a disposition of the improvement.
- b. Nonresidential Property. The 2004 AJCA reduces the recovery period to 15 years for “qualified leasehold improvements” to nonresidential real property placed in service after October 22, 2004 and before January 1, 2006. § 168(e)(7)(E)(iv), (e)(6).
 - i. Notwithstanding the 15-year recovery period, a qualified leasehold improvement must be depreciated on a straight-line basis. § 168(b)(3)(G).
 - ii. A “qualified leasehold improvement” is an improvement to the interior of nonresidential real property if:
 - the improvement is made pursuant to a lease (or commitment to enter into a lease) by the lessee, a sublessee or the lessor,
 - the building (or portion to which the improvement is made) is occupied exclusively by the lessee (or sublessee),
 - the improvement is placed in service more than 3 years after the date the building was placed in service,

- the improvement is not an enlargement of the building, an elevator or escalator, a structural component that benefit a common area, or internal structural framework for the building, and
 - the lessee and lessor are not related persons (*i.e.*, members of an affiliated group under § 1504, or related persons under § 267(b) substituting “80 percent or more” for “more than 50 percent”). § 168(e)(6) (referring to § 168(k)(3).
- iii. A qualified leasehold improvement made by a lessor does not constitute a qualified leasehold improvement of any subsequent owner. The limitation, however, does not apply in the case of death or certain transfers that qualify for nonrecognition treatment. § 168(e)(6).
- iv. Qualified leasehold improvements placed in service before January 1, 2005 also qualified for bonus depreciation. § 168(k).
- c. Restaurant Improvements. Congress recognized that because of the nature of the business, restaurants generally have a shorter life span than other commercial buildings, and generally require more frequent repair and upgrades. As a result, the 2004 AJCA requires “qualified restaurant property” that is placed in service after October 22, 2004 and before January 1, 2006 to be depreciated using the straight-line method over 15 years. § 168(b)(3)(H), (e)(3)(E)(v).
- i. “Qualified restaurant property” is defined as an improvement to a building that is place in service more than 3 years after the date the building was first placed in service if more than 50 percent of the building (based on square feet) is devoted to the preparation of, and seating for on-premises consumption of, prepared meals. § 168(e)(7).

2. Principal Residence Acquired in Like-Kind Exchange

- a. General. An individual can exclude up to \$250,000 (\$500,000 if the individual is married and files a joint return) of gain from the sale of property that the individual owned and used by the individual as his principal residence for at least 2 of the last 5 years. The individual may qualify for a reduced exclusion if the ownership and use tests are not met due to special circumstances. § 121.
- b. Limitation. The 2004 AJCA limits the exclusion with respect to property acquired within 5 years before the sale in a like-kind exchange in which any gain was not recognized. The limitation is effective for sales of principal residences after October 22, 2004. § 121(a)(11).

- i. This increases the required holding period for residences acquired in a like-kind exchange from 2 years to 5 years.

3. Certain Rules Relating to REITs

a. 10% Value Asset Test.

- i. **Prior Law.** Before the 2004 AJCA, in order to satisfy certain asset tests, a REIT could not own more than 10% of the value of the outstanding securities of a single issuer (the “10% Value Test”). Securities of an issuer that qualified as “straight debt” were not subject to the 10% Value Test if (A) the issuer was an individual, (B) the only securities of such issuer held by the REIT were straight debt or (C) the issuer was a partnership and the REIT held at least a 20% profits interest in the partnership.

Straight debt was defined as a written or unconditional promise to pay on demand or at a specified time a certain sum in money if (A) the interest rate (and interest payment dates) were not contingent on profits, the issuer’s discretion or similar facts and (B) there was no convertibility into stock.

- ii. **Exempt Securities.** The 2004 AJCA replaced the straight debt safe harbor and provides that the following will not be considered securities for purposes of the 10% Value Test:
 - straight debt securities (as defined below);
 - a loan to an individual;
 - a § 467 rental agreement, as defined in § 467(d), except for an agreement with certain related persons;
 - certain obligations to pay rents from real property;
 - a security issued by a State or its political subdivisions, the District of Columbia, a foreign government or its political subdivisions, or Puerto Rico, but only if the determination of a payment received or accrued under the security does not depend, in whole or in part, on the profits of any entity listed in this category or on the payments on an obligation issued by such an entity;
 - a security issued by a REIT; and
 - any other arrangement determined by the Secretary.
§ 856(m)(1)(A) - § 856(m)(1)(G).

iii. Straight Debt. While the 2004 AJCA continues to define straight debt securities as noncontingent nonconvertible debt securities, interest or principal payments do not fail to meet the noncontingency test merely because (A) the timing of the payment is contingent, provided, that the contingency does not change the effective yield to maturity by more than the greater of .25% or 5% of the annual yield to maturity, or neither the aggregate issue price nor the aggregate face of the issuer's debt instruments held by the REIT exceeds \$1,000,000 and not more than 12 months of unaccrued interest can be required to be prepaid or (B) the time or amount of payment is subject to a contingency on a default or because of a prepayment right of the issuer of the debt, provided, that the contingency is consistent with customary commercial practice. § 856(m)(2)(B).

iv. Partnership Interests and Securities. For purposes of the 10% Value Test, partnership interests held by a REIT are not treated as securities. Instead, the REIT is deemed to own its proportionate share of each asset of the partnership. For purposes of applying this rule, the value of any debt instrument is the adjusted issue price of the instrument as defined for purposes of the § 1272. Further, under the 2004 AJCA, debt instruments issued by a partnership and not qualifying for any of the safe harbors are not considered securities to the extent of the REIT's partnership interest, or, if at least 75% of the partnership's gross income (excluding gross income from prohibited transactions) is derived from sources that would be qualifying income for purposes of the 75% gross income test that applies to REITs. § 856(m)(3)(B).

b. REIT Income Tests

i. Rents from a Taxable REIT Subsidiary ("TRS") . Under the 2004 AJCA, rents from a TRS are not disqualified from being rents from real property because of the related party provisions if at least 90% of the leased space of the property is rented to persons other than a TRS and certain other related persons and the amount paid to the REIT by the TRS as rents from real property (without regard to the exclusion of rents paid by unrelated persons) are substantially comparable to the rents paid by other tenants of the REIT's property for comparable space. The substantial comparability requirement shall be treated as met with respect to a lease to a REIT's TRS if such requirement is met (A) at the time the lease is entered into, (B) at the time of each extension of the lease, including a failure to exercise a right to terminate, and (C) at the time of any modification of the lease between the REIT and the

TRS if the rent under the lease is effectively increased under the modification. § 856(d)(2)(B) and 856(d)(8).

- ii. Income from Hedging Transactions. Under the 2004 AJCA, income from certain hedging transactions does not constitute gross income for purposes of the 95% income test. Specifically, except to the extent provided by regulations, any income of a REIT from a hedging transaction (as defined § 1221(b)(2)(A)(ii) or (iii)) that is clearly identified as such pursuant to § 1221(a)(7), including gain from the sale or disposition of such a transaction, shall not constitute gross income under for purposes of the 95% income test to the extent that the transaction hedges any indebtedness incurred or to be incurred by the REIT to acquire or carry real estate assets. § 856(c)(5)(G).

c. REIT Saving Provisions

- i. Asset Test Violations. Under prior law, a violation of one or more of the asset tests applicable to a REIT would result in loss of REIT status for such taxable year. Under the 2004 AJCA, a REIT will no longer lose such status because of the failure to satisfy the 5% and/or 10% asset tests for a particular quarter of the taxable year; provided that (A) such failure is attributable to the presence of assets, the total value of which does not exceed the lesser of 1% of the value of the REIT's total assets at the end of a quarter for which such determination is made or \$10,000,000 (the "*de minimis* amount") and (B) the REIT disposes of the assets needed to satisfy the 5% and/or 10% asset tests within six (6) months after the last day of the quarter in which such failure takes place or otherwise satisfies such requirements by the end of such six (6) month period. § 856(c)(7)(A).

Further, under the 2004 AJCA, if one of the other REIT asset tests is not satisfied or if the 5% and/or 10% asset tests are violated by more than the *de minimis* amount, a REIT may not lose its status provided that the REIT can satisfy certain requirements and is willing to pay a tax of at least \$50,000. § 856(c)(7)(B) and § 856(c)(7)(C).

- ii. Income Test Violations. Under prior law, the failure of a REIT to satisfy the 75% and/or 95% income tests did not automatically result in the loss of REIT status, provided, that (A) the failure was due to reasonable cause and not willful neglect, (B) the REIT attached a schedule to its income tax return for the taxable year setting forth the nature and amount of each item of gross income that was qualified income for purposes of the 75% and 95%

income tests and (C) the REIT paid a tax equal to a specified fraction multiplied by the greater of the amount by which:

- 90% of the REIT's gross income (excluding prohibited transactions income) exceeded the amount of items qualifying under the 95% income test; or
- 75% of the REIT's gross income (excluding prohibited transactions income) exceeded the amount of items subject to the 75% test.

Under the 2004 AJCA, a REIT will not lose its status solely as a result of failing to satisfy the 75% and/or 95% income tests, but the calculation of the tax that will be owed by the REIT has been modified to equal a specified fraction multiplied by the greater of the amount by which:

- 95% (*rather than 90%*) of the REIT's gross income (excluding prohibited transactions income) exceeded the amount of items qualifying under the 95% income test; or
- 75% of the REIT's gross income (excluding prohibited transactions income) exceeded the amount of items subject to the 75% test. § 857(b)(5).

- d. REIT Distributions Excluded from FIRPTA. Prior to the 2004 AJCA, a look-through rule applied to treat REIT distributions attributable to sales or exchanges of United States real property interests ("USRPIs") by the REIT as dispositions of USRPIs by the distribution recipient for purposes of FIRPTA. Under the 2004 AJCA, notwithstanding the look-through rule, any distribution by a REIT on a class of stock that is regularly traded on an established securities market located in the United States will not be treated as gain recognized from the sale or exchange of a USRPI if the shareholder did not own more than 5% of the class of stock at any time during the tax year. § 857(h)(1).
- e. Effective Dates. In general, the modifications to the REIT rules discussed above will be effective for taxable years beginning after October 22, 2004. However, the modified provisions relating to straight debt are effective for taxable years beginning after December 31, 2000.

B. Facade Easements

1. Deduction. A taxpayer is entitled to a deduction for a contribution of a “qualified real property interest” to a “qualified organization” “exclusively for conservation purposes.” § 170(h)(1).
 - a. Qualified Real Property Interest. A “qualified real property interest” includes a restriction granted in perpetuity on the use which may be made of real property. § 170(h)(2)(C). This includes a perpetual facade easement.
 - b. Qualified Organization. A “qualified organization” includes a charitable organization that normally receives a substantial portion of its support from a government unit or the general public. § 170(h)(3).
 - i. The organization must have a commitment to protect the conservation purposes of the donation and have the resources to enforce the restrictions. A group organized or operated primarily or substantially for conservation purposes is considered to have the required commitment. Reg. § 1.170A-14(c)(1). To meet the resource requirement, the organization often requires a cash contribution in addition to the easement.
 - ii. The contribution instrument must prevent the qualified organization from transferring the easement, unless the transfer is to a qualified organization and requires the conservation purpose to be carried out. If an unexpected change in the conditions surrounding the property make it impossible or impractical to continue to use the property for conservation purposes, the requirement is met if the property is sold and the proceeds are used for such conservation purposes. Reg. § 1.170A-14(c)(2).
 - c. Exclusively for Conservation Purposes. “Conservation purposes” include the preservation of an historically important land area or a building that is listed in the National Register or is located in a registered historic district and is certified by the Secretary of the Interior to the IRS as being of historic value to the district. § 170(h)(4).
 - i. Some portion of the property must be visible to the public (either from a public road or regular access). Reg. § 1.170A-14(d)(5)(iv).
 - ii. “Exclusively” requires that the conservation purpose be protected in perpetuity. § 170(h)(5). The restriction must be legally enforceable in perpetuity. Reg. § 1.170A-14(g)(1).

- iii. If the property is subject to a mortgage, the mortgagee must subordinate its rights in the property to the qualified organization. Reg. § 1.170A-14(g)(2).
 - iv. If a subsequent unexpected change in the conditions surrounding the property can make it impossible or impractical to continue to use the property for conservation purposes, the conservation purpose is treated as protected if the restrictions are extinguished by judicial proceeding and all of the donee's proceeds from a subsequent sale of the property are used by the donee organization in a manner consistent with the conservation purpose. The donee must agree that the contribution gives rise to a property right, immediately vested in the donee organization, with a value at least equal to the proportional value that the restriction at the time of the contribution bears to the value of the property as a whole at such time. Accordingly, when a change in conditions gives rise to the extinguishment of the restriction, upon a subsequent sale, exchange or involuntary conversion of the property, the donee organization must be entitled to a portion of the proceeds at least equal to that proportionate value, unless state law provides that the donor is entitled to the full proceeds without regard to the prior restriction. Reg. § 1.170A-14(g)(6).
2. Value. The amount of the deduction is the value of the perpetual conservation restriction.
- a. Before and After Test. Generally, such value is determined by subtracting the value of the property subject to the restriction from the value immediately before the restriction. Reg. § 1.170A-14(h)(3). Accordingly, if the value of the property is not affected by the restriction (or is enhanced), no deduction is allowed.
 - i. The few courts that have considered the issue have valued the facade easement at 10 percent or more of the before value of the property. *Nicholadis v. Comr.*, T.C. Memo 1983-163 (10%); *Hilborn v. Comr.*, 85 T.C. 677 (1985) (10%); *Richmond v. U.S.*, 699 F. Supp. 578 (D.C. La. 1988) (15%); *Losch v. Comr.*, T.C. Memo 1988-230 (16.77%); *Griffin v. Comr.*, T.C. Memo 1989-130, *aff'd*, 911 F.2d 1124 (5th Cir. 1990) (20%); *Dorsey v. Comr.*, T.C. Memo 1990-242 (10%). Of course, the taxpayer claimed a higher value and the IRS generally claimed a lower one.
 - ii. A memorandum from the National Park Service prepared by Mark Primoli of the IRS states that IRS Engineers have concluded that the value of a facade easement should range from approximately 10-15 percent of the before value of the property. <http://www2.cr.nps.gov/tps/tax/IRSFacade.htm>.

- iii. How much does the value of property really decline as a result of a facade easement? State law often limits the taxpayer's ability to make changes to the facade.
 - b. **Limitation.** No deduction is allowable, however, if the donor (or a related person) receives (or can reasonably be expected to receive) financial or economic benefits that are greater than those that will inure to the general public. If the donor (or a related party) receives (or can reasonably be expected to receive) a financial or economic benefit that is substantial (but clearly less than the amount of the transfer), the deduction is limited to the excess of the amount transferred over the amount of the financial or economic benefit. Reg. § 1.170A-14(h)(3).
 - c. **Basis.** The donor's basis in the property immediately before the contribution is allocated between the restriction and the retained portion of the property. The amount allocable to the restriction bears the same ratio to the total basis as the value of the restriction bears to the value of the property before the contribution. The balance is allocable to the retained property. In the case of a restriction on depreciable property, the basis of the retained property must be allocated between the building and the underlying land. Reg. § 1.170A-14(h)(3)(iii).
 - d. **Substantiation.** The taxpayer must retain written records of the value of the property before and after the contribution. Such information and conservation purpose must be stated on the taxpayer's income tax return. Reg. § 1.170A-14(i).
- 3. **Abuse.** The IRS is aware that taxpayers have been claiming deductions for contributions of conservation easements in excess of the appropriate value. The IRS put taxpayers on notice that, in appropriate cases, it will disallow the deductions and impose penalties. The IRS also warned the tax-exempt organizations, promoters and appraisers that they may also be subject to penalties. Notice 2004-41.
- 4. **Proposed Legislation.** Senators Grassley and Baucus announced that they are going to introduce legislation to increase fines and penalties on taxpayers, promoters and appraisers who participate, and or assist in the donation of facade easements that are found to be significantly overvalued. Tax Notes Today (12/17/04).
 - a. "... it's ridiculous for people in Georgetown to take tens of thousands of dollars in charitable tax deductions for agreeing not to put aluminum siding on their million-dollar brick houses when local laws and regulations already prohibit such activity."
 - b. Grassley and Baucus also called upon the IRS to make review of façade easements a priority for audit.

C. Recent Development Affecting Like-Kind Exchanges

1. Reverse Exchanges

- a. Safe Harbor. Rev. Proc. 2000-37 provides a safe harbor for “parking” transactions.
 - i. Parking transactions typically are designed to “park” the desired replacement property with an accommodation party until such time as the taxpayer arranges for the transfer of the relinquished property to the ultimate transferee in a simultaneous or deferred exchange. Once the transfer is arranged, the taxpayer transfers the relinquished property to the accommodation party in exchange for the replacement property, and the accommodation party transfers the relinquished property to the ultimate transferee.
 - ii. In other situations, an accommodation party may acquire the desired replacement property on behalf of the taxpayer and immediately exchange that property with the taxpayer for the relinquished property. The accommodation party holds the relinquished property until the taxpayer arranges for a transfer of the property to the ultimate transferee.
- b. Ownership. Rev. Proc. 2000-37 provides that the IRS will not challenge the qualification of property held in a qualified exchange accommodation arrangement as replacement property or relinquished property, or the treatment of the exchange accommodation titleholder (“EAT”) as the beneficial owner of the property. Taxpayers are not required to establish that EAT bears the economic benefits and burdens of ownership of the property.
 - i. The IRS is aware that some taxpayers have interpreted this language to permit a taxpayer to treat as a like-kind exchange a transaction in which the taxpayer transfers property to an EAT and receives the same property as replacement property in a purported exchange for other property of the taxpayer.
 - ii. It is unlikely a court would have agreed with the taxpayer. *See, e.g., DeCleene v. Comr.*, 115 T.C. 457 (2000); *Bloomington Coca-Cola Bottling Co. v. Comr.*, 189 F.2d 14 (7th Cir. 1951). Clearly, that was not the intended purpose of the safe harbor.
- c. Clarification. The IRS clarified that the safe harbor treats the EAT as the owner of the property only if the exchange otherwise meets the requirements of § 1031. Rev. Proc. 2004-51.

- d. Exception for Reacquisition. The IRS also provided that the safe harbor does not apply if the taxpayer owned the replacement property within 180 days before it is acquired by the EAT. Rev. Proc. 2004-51.

2. Delaware Statutory Trusts

- a. Grantor Trust. The acquisition of an interest in a grantor trust constitutes the acquisition of a proportionate interest in the property owned by the trust for purposes of § 1031. Rev. Rul. 2004-86.
 - i. This is consistent with the treatment of grantor trusts under other sections of the Code. *See, e.g.*, Rev. Rul. 88-103; Rev. Rul. 85-45; Rev. Rul. 85-13; Reg. § 1.1001-2(c) Ex. 5.
 - ii. Nongrantor trust interests and partnership interests cannot be exchanged in a like-kind exchange. § 1031(a)(2)(D), (E).
- b. Facts. In the ruling:
 - i. Individual A borrowed money from a bank in exchange for a 10-year promissory note. A used the proceeds to purchase Blackacre, rental real property. The loan is nonrecourse to A, and is secured by Blackacre.
 - ii. Immediately following the purchase, A leases Blackacre to Z pursuant to a 10-year net lease.
 - iii. On the same day, A transfers Blackacre subject to the note and lease to a Delaware statutory trust created by A. The trust terminates in 10 years or upon the earlier disposition of Blackacre.
 - iv. The trustee is required to distribute all available cash (in excess of reasonable reserves for expenses associated with Blackacre) quarterly. The trustee must invest cash received between distribution dates and reserves in U.S. obligations or bank C.D.s that mature prior to the next distribution date, and must hold the obligation until maturity.
 - v. The activities of the trust are limited to the collection and distribution of income. The trustee cannot dispose of Blackacre, purchase assets (other than the short-term investments), or accept additional contributions. The trustee cannot renegotiate the terms of the note or lease (except in the case of Z's bankruptcy or insolvency), or enter into other leases. The trustee may only make minor non-structural modifications to Blackacre (unless otherwise required by law). The trustee may engage in ministerial activities.

vi. B and C exchanged real property for A's beneficial interest in the trust.

c. Analysis.

i. Under Delaware law, a Delaware statutory trust is treated as an entity separate from its owners. The owners are not liable for the debts or obligations of the trust.

ii. Since there was only one class of ownership interest and the trustee did not have the power to vary the investments (other than to make short-term investments that mature prior to the next quarterly distribution date), the entity was classified as a trust. Reg. § 301.7701-4(c)(1).

iii. X was treated as the owner of the trust since the income from the trust is distributed to X or held for X's benefit. § 677(a).

iv. A grantor includes a person who acquires an interest in the trust from the grantor. Reg. § 1.671-2(e)(3). As a result, B and C are grantors, and are considered to own their proportions of the trust.

v. A grantor who is treated as the owner of all or a portion of a trust is considered to own his proportionate share of the assets owned by the trust.

d. Fact Specific. The IRS warned that the ruling is fact specific. Whether a Delaware statutory trust constitutes a trust or a business entity depends on the powers of the trustee. Even if it is treated as a trust, whether the trust constitutes a grantor trust depends on its terms.

i. The facts in the ruling do not reflect a typical financing. Generally, the bank will want to lend directly to the trust. Moreover, the limitations on the trustee's actions may make it difficult to comply with the terms of the loan.

3. Related Party Exchanges

a. Related Party Rule. If (A) a taxpayer exchanges property with a related person, (B) there is nonrecognition of gain or loss to the taxpayer under § 1031, and (C) within 2 years after the exchange, either the taxpayer or the related person disposes of the property received in the exchange, the taxpayer must recognize the deferred gain as of the date of the second disposition. § 1031(f)(1).

- b. Exceptions.
 - i. The rule does not apply to a second disposition (A) after the death of the taxpayer or related person, (B) in an involuntary conversion under § 1033 if the exchange occurred before the threat or imminence of such conversion, or (C) if it is established to the satisfaction of the IRS that neither the exchange nor the second disposition has as one of its principal purposes the avoidance of federal income tax. § 1031(f)(2).
 - ii. § 1031 does not apply to an exchange that is part of a transaction or series of transactions structured to avoid the related party rules. § 1031(f)(4).
 - c. Application.
 - i. A taxpayer's transfer of relinquished property to a qualified intermediary in exchange for replacement property that was formerly owned by a related party was held to be for the purpose of avoiding § 1031(f)(1) where the related party sold the replacement property for cash. As a result, the exchange was taxable. Rev. Rul. 2002-83.
 - ii. However, if the related party disposes of the replacement property in a like-kind exchange in which no gain is recognized, § 1031(f) does not apply. PLR 200440002. The purpose of the rule is to prevent the related party from cashing out the investment. The non-tax avoidance exception generally applies if the second disposition is a nonrecognition transaction. H.R. Rep. No. 386, 101st Cong., 1st Sess. 613 (1989). The property received by the related person in the second disposition retains the same low basis the related person had in the replacement property.
4. Election Out of Subchapter K
- a. Limitation on § 1031. If property is owned by a partnership, a like-kind exchange of the property must generally be made by the partnership. Transfers of partnership interests do not qualify under § 1031. § 1031(a)(2)(D).
 - b. Election Out. An investment partnership that elects under § 761(a) to be excluded from all of subchapter K is disregarded, and the partners are considered to own the property as tenants-in-common for purposes of § 1031.
 - i. To make the election regarding investment property, the participants must:

- own the property as co-owners,
 - reserve the right separately to take or dispose of their shares of any property acquired or retained, and
 - not actively conduct business or irrevocably authorize some person acting in a representative capacity to purchase, sell or exchange the investment property, although each separate participant may delegate authority to purchase, sell or exchange the participant's share of such investment property for the participant's account for a period of not more than 1 year. Reg. § 1.761-2(a)(2).
- ii. The IRS has advised that partnership and limited partnerships formed under state law are not eligible to elect out of subchapter K. FSA 199923017; FSA 200216005. Presumably, the IRS also believes limited liability companies similarly cannot make the election. Owners of such entities do not have the right to take their share of the entities' property at will.
- c. Possible Modification. The IRS is considering whether the conditions for electing out of subchapter K under § 761(a) should be revised, modified or clarified. Notice 2004-53.
- i. The IRS requested comments on the circumstances under which participants should be treated as owning the investment property as co-owners for purposes of electing out of subchapter K.
- ii. Comments were also requested on the facts that should be considered in determining whether the participants have reserve the right separately, to take or dispose of their underlying shares in the property. For example, should an agreement with a third party (such as a lender) that limits the rights of co-owners to take or dispose of their underlying shares in the investment property prohibit the participants from electing to be excluded from subchapter K. Is the IRS changing its position? Rev. Proc. 2002-22, which sets forth the IRS's ruling guidelines for determining whether a fractional interest constitutes an interest in the real property as a tenant-in-common or an interest in a business entity, expressly permits restrictions on transfers that are required by a lender if they are consistent with customary commercial lending practices.
- iii. Comments were also requested on the meaning of investment property for this purpose, including whether rental real estate is or can be treated as investment property.

D. Sale of Home May Qualify for Exclusion and Like-Kind Exchange

1. Exclusion. A taxpayer may exclude up to \$250,000 (\$500,000 if the taxpayer is married and files a joint return) of gain from the sale of property that was owned and used by the taxpayer as his principal residence for at least 2 years during the 5-year period before the sale. § 121.
 - a. Dual Use of Dwelling Unit. The exclusion applies if even the dwelling unit was also used for nonresidential purposes. Reg. § 1.121-1(e)(1). In such case, however, gain must be recognized to the extent of the post-May 6, 1997 depreciation that is recaptured. § 121(d)(6).
 - b. Separate Property. The exclusion does not apply to any portion of the property separate from the dwelling unit that was used for nonresidential purposes. In such case, the purchase price must be allocated between the principal residence and the nonresidential portion using the same method the taxpayer used to compute the depreciation. Reg. § 1.121-1(e).
2. Like-Kind Exchange. No gain or loss is recognized upon the exchange of property held for productive use in a trade or business or for investment (“business use”) solely for property of a like kind that is to be held for productive use in a trade or business or for investment. § 1031(a).
 - a. Boot. If nonqualifying property (“boot”) is also received, gain is recognized to the extent of the lesser of the gain realized or the value of the boot. § 1031(b).
 - b. Basis. The taxpayer's basis in the nonqualifying replacement property is its value. The taxpayer's basis in the qualifying replacement property is the equal to his basis in the relinquished property, plus any gain recognized and minus the value of any boot received. § 1031. As a result, the unrecognized gain is preserved in the qualifying property.
3. Exclusion and Involuntary Conversion. A taxpayer can qualify for both the exclusion under § 121 and in involuntary conversion under § 1033.
 - a. Under § 1033, gain is generally recognized to the extent the amount realized from an involuntary conversion exceeds the cost of the qualifying replacement property. § 1033(a). The taxpayer's basis in the qualifying replacement property is its cost, reduced by the amount of gain that was not recognized. § 1033(b).
 - b. Where both § 121 and § 1033 apply, the amount realized for purposes of § 1033, is equal to the value of the relinquished property minus the gain excluded under § 121. § 121(d)(5)(B). As a result, (A) the § 121 exclusion is applied to the gain before the application of § 1033, (B) in determining the gain that may be deferred under § 1033, the § 121

exclusion is applied first against amounts received that are not reinvested in the replacement property (i.e., amounts that would otherwise result in gain under § 1033), and (C) the gain excluded under § 121 is included in the taxpayer's basis in the replacement property.

4. Exclusion and Like-Kind Exchange. A taxpayer can also qualify for both the exclusion under § 121 and a like-kind exchange under § 1031. The IRS applies the same rules as for involuntary conversions. Rev. Proc. 2005-14.
 - a. As a result, (A) § 121 is applied to the gain realized before the application of § 1031, (B) although § 121 does not apply to depreciation recapture with respect to business use of the property, § 1031 may apply, (C) in applying § 1031, boot received in exchange for relinquished business property is taken into account only to the extent it exceeds the gain excluded under § 121 with respect to the relinquished business property, and (D) the taxpayer's basis of the replacement business property under § 1031(d) is increased by any gain attributable to the relinquished business property that is excluded under § 121.
 - b. Example 1. A, a single individual, buys a house for \$210,000 that he uses as his principal residence for 4 years. For the next 2 years, A rents the house and claims \$20,000 of depreciation deductions. In year 6, A exchanges the house for \$10,000 cash and a townhouse with a value of \$460,000 that A intends to rent to tenants. A realizes \$280,000 ($\$10,000 + \$460,000 - (\$210,000 - \$20,000)$) of gain on the exchange

§ 121 applies to exclude \$250,000 of gain before the application of § 1031. A may defer the remaining \$30,000 of gain, including the \$20,000 gain attributable to the depreciation, under § 1031. A is not required to include the \$10,000 boot in income since it is less than the excluded gain. A's basis in the townhouse is \$430,000, which is equal to the basis in the relinquished property ($\$210,000 - \$20,000$), increased by the gain excluded under § 121 (\$250,000), and reduced by the boot received (\$10,000).
 - c. Example 2. B, a single individual, buys two separate dwelling units for \$210,000. B uses one for his principal residence and use the other as his office. Based on square footage, B allocates 2/3 of the purchase price to the principal residence and 1/3 to the office. B's depreciation deductions with respect to the office are \$30,000. Six years later, B exchanges the two units for a residence with a value of \$240,000, and a separate property that B intends to use as an office, which like the relinquished business property, has a value of \$120,000.

For purposes of determining gain, B allocates the sale price and his initial cost basis in the same manner as was allocated for purposes of determining depreciation. Accordingly, B recognizes \$100,000 ($2/3 \times$

$(\$240,000 + \$120,000) - 2/3 \times \$210,000$) of gain with respect to the principal residence and $\$80,000 (1/3 \times (\$240,000 + \$120,000) - (1/3 \times \$210,000 - \$30,000))$ of gain with respect to the office.

Under § 121, B may exclude the \$100,000 gain with respect to the office. Because the office is separate from the dwelling unit used as B's principal residence, B may not exclude any gain allocable to the office under § 121. It is separate from the dwelling unit and B has not met the § 121 use requirements with respect to it. However, § 1031 applies to the exchange of the business property. Since the value of the replacement business property is equal to the value of the relinquished business property and no boot is received, § 1031 defers the entire \$80,000 gain allocable to the business property. B's basis in the new residence is its \$240,000 purchase price, and B's basis in the new office is equal to the \$40,000 substituted basis from the relinquished business property ($1/3 \times \$210,000 - \$30,000$).

- d. Example 3. The facts are the same as in Example 2, except that the residences and business property are part of the same dwelling unit. As under Example 2, B realizes \$1,000,000 of gain with respect to his principal residence, and \$80,000 of gain with respect to the office. However, because they are part of the same dwelling unit, § 121 applies not only to exclude the \$100,000 gain with respect to the principal residence, but also \$50,000 ($\$80,000 \text{ gain} - \$30,000 \text{ of depreciation}$) of gain with respect to the office. The remaining \$30,000 of gain is deferred under § 1031. In such case, B has a basis of \$240,000 in the new residence and \$90,000 ($\$40,000 \text{ substituted basis} + \$50,000 \text{ of gain excluded under § 121 with respect to the business property}$) in the new office.
- e. Example 4. The facts are the same as Example 3, except the replacement property consists of a \$240,000 residence, \$10,000 in cash and a \$110,000 office. B similarly excludes \$150,000 ($\$100,000 \text{ with respect to the principal residence} + \$50,000 \text{ with respect to the business portion}$) of gain under § 121, and the remaining \$30,000 under § 1031. The \$10,000 boot is not required to be included in income because it is less than the \$50,000 of gain with respect to the business portion that is excluded under § 121. As a result, B's basis is \$240,000 in the new residence, and \$80,000 ($\$40,000 \text{ substituted basis} + \$50,000 \text{ gain excluded} - \$10,000 \text{ boot}$) in the new office.