

The Real Estate Exchange Company



# Tax Alert Newsletter

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<http://www.1031help.com>

Realty Exchangers Tax Alert is a **FREE** biweekly newsletter published by Realty Exchangers University as a part of their exceptional educational program for the real estate community.

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If you have questions regarding this newsletter or 1031 Exchanges, please contact [askrich@1031university.com](mailto:askrich@1031university.com) or visit our web site at <http://www.1031help.com>.

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## Announcements

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Realty Exchangers, Inc. is a **QUALIFIED INTERMEDIARY** for Deferred Exchange transactions and specifically structured to assist Exchangers and Real Estate Professionals in effecting successful IRC '1031 Deferred Exchanges. We fully understand the real estate transaction, the needs of the investor, and the technical requirements of the IRS. Realty Exchangers, Inc. can initiate documentation for delayed exchanges with as little as two hours notice and furnish all the paperwork and necessary forms. We also consult with real estate professionals, tax consultants, and legal advisors involved in the exchange. We are dedicated to providing the fastest and most accurate service available.

Now in our twelfth year of providing fast and accurate service to all fifty states and the U.S. Virgin Islands, we are fully computerized and process all of our transactions by electronic transfer. Wherever you're located we're as close as your phone. Whether you're in need of our services as your Qualified Intermediary, or just have questions, please call us (1-800-570-1031). We'll be happy to hear from you and help you in any way we can.

- Visit our site at <http://www.1031help.com>

- For a great new library of 1031 information, visit <http://www.realtyexchangersuniversity.com/2-procmanual.htm>
  - And sure to visit the REU Bookstore at <http://www.realtyexchangersuniversity.com/1-bookstore.htm>
  - For a review of the new Realty Exchangers 1031 Exchange Manual, aim your browser at <http://www.realtyexchangersuniversity.com/2-procmanual.htm>
  - If you have 1031 questions or would like to comment on our newsletter, please E-mail [askrich@1031university.com/](mailto:askrich@1031university.com)
  - And be sure to visit the REU On-line campus at <http://www.realtyexchangersuniversity.com> where we have added lots of new material and information regarding 1031 deferred exchanges.
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## **IRS Offers Details on How to Avoid Being a Partnership**

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For the text of Rev. Proc 2002-22, 2002-14 IRB 7733, visit Realty Exchangers University on-line Research Library:

<http://www.realtyexchangersuniversity.com/RevProc-2002-22.htm>

This very significant ruling details conditions for considering a request for a ruling that an undivided fractional interest in rental real property is not an interest in a business entity. The ruling applies to co-ownership of rental real property in an arrangement classified under local law as a tenancy-in-common.

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## **Jim Maxwell Explains Some Personal Residence Tax Considerations**

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Section 1031 and the related regulations make it very clear that real estate held for personal use cannot qualify for 1031 treatment. However, sometimes the residence gets involved in an exchange and the subject can

get quite complicated. We offer this "nutshell" study to help you understand more about the tax part of the personal residence when structuring an exchange with personal residence considerations.

For tax purposes, the term personal residence refers to the place in which you principally reside. If you have more than one home, only your principal home qualifies as your personal residence.

Your personal residence includes the dwelling unit and the land it's located on. The land alone, however, is not a residence. If part of the land is sold, but not the dwelling unit, the land sold is not treated as the sale of a residence. For example, Hale lived in a trailer on thirty-nine acres he owned. He sold the land and continued to live in the trailer on the land rent-free for two years. Then he moved into a houseboat that became his residence.

But he never sold the trailer. Since the Tax Court said that since the sale of the land did not qualify as the sale of a personal residence (real estate held for personal use), it was treated as the sale of real estate held for investment, which can qualify for 1031 treatment. Some good tax ideas here.

Caution: Sometimes a series of sales transactions is necessary to sell the property. If part of the land is sold separately, and the dwelling unit is sold as part of the series of sales, all the sales are lumped together and are treated as the sale of a personal residence.

In IRS Letter Ruling 8940061, the taxpayer bought 5 acres of land contiguous to his fifteen-acre personal residence. He cleared and landscaped the 5 acres, making it an addition to his residence. He did not develop the land separately. The IRS said the land was part of his principal residence.

A condominium is treated by the IRS as a personal residence if occupied by you as your primary residence. You receive legal title in fee simple to a unit in the multi-unit building. Also, you get ownership of an undivided interest in the land and common areas with the other owners of individual units. If you use your condominium as your primary residence, and sell it, the rules applying to the sale of your personal residence will apply.

However, if you use your condominium as rental income property, all the rental deduction and income rules apply and it may qualify for 1031 treatment.

The cooperative form of ownership is similar to condominium ownership. Both involve the collective control of certain facilities of the project and

common areas. The difference between the two is the way title is held. The condo owner has fee simple title in a specific unit. The development's facilities and common areas are jointly owned with other condo owners. Under cooperative ownership, a corporation owns the entire residential building. Each "tenant" owns stock in the corporation and leases a particular apartment from the corporation with rights to occupy the apartment as his or her personal residence. The stock owned by the "tenant" is treated by the IRS as the equivalent to ownership of a personal residence.

Selling stock in a cooperative is treated as the sale of your personal residence. However, if you use your cooperative as rental income property, all the rental deduction and income rules apply and it may qualify for 1031 treatment.

The fact you rent out your residence does not necessarily mean the property loses its classification as your personal residence. You must look at the facts and circumstances of each case to determine this. This presents a real danger if the primary purpose of converting your residence to a rental is to qualify for a subsequent 1031 exchange.

Renting out your old residence for a temporary period during the time you are making a serious effort to sell it will not convert it from a personal residence to rental income property. In one case, the taxpayer moved to a new job location. He rented his old residence until it could be sold. Because his main motive was to sell the residence as soon as possible and not hold it as rental property guaranteed the sale would be treated as the sale of a personal residence. This treatment is applied because the residence was held primarily for sale and not for use in the rental business.

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## **"Short Sale" of Your Personal Residence**

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One big tax trap that snares many homeowners is a proceeding called the "short sale". Homeowners with a personal residence worth less than the mortgage balance are working out agreements with lenders to lower the loan balance as part of a plan to allow a short sale of the property. The trap is the "forgiveness of debt" rule and the amount of discount may end up on your tax return as ordinary income.

If your lender offers a discount for payoff of the mortgage debt, the amount of the discount is treated as cancelled debt and you must include this amount on your individual tax return Form 1040 as ordinary income. In a nonrecourse loan state, the entire unpaid balance is treated as discharged

and there is no deficiency judgment for the difference. None of the gain is treated as ordinary income. It is treated as capital gain and may qualify for the Section 121 exclusion.

If you do a workout with the lender resulting in a reduction of the loan balance and keep the property (or sell it later but not as a part of a step transaction linked to the workout agreement), the forgiveness of debt will be recognized as ordinary income at the time of the workout agreement.

Another situation calls for caution. If you purchase real estate - business or personal use - and the seller reduces the amount of debt you owe for the property, you do not recognize income under the forgiveness of debt rule. Instead, the reduction in debt is treated as a purchase price adjustment and reduces your basis in the property.

As in many tax situations, there are some special exceptions to these rules such as bankruptcy, farm debt, and insolvency. If you get into any real estate transaction with forgiveness of debt is involved, check immediately with your tax professional and attorney.

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## Questions and Answers

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Every day we get questions about the tax part of real estate exchanges. Many questions are on the same subject, so we will report to you a selection of these questions and answers.

### *Question from SS*

When you do a tax-deferred exchange, can you deduct your points and closing costs?

**RE's Answer:** Points must be capitalized and written off straight-line over the life of the loan. If the property is Section 1225 investment land, the write off is treated as investment interest. If the property is Section 1231 business property such as rentals, the points are written off as interest expense on your rental property Schedule E.

All closing costs directly related to the sale or purchase of property such as commissions, title policy, escrow fees, and such, are treated this way:

On Sale of Business or Investment Property - Deducted from the sales price in figuring the gain or loss on the sale.

On Purchase of Business or Investment Property - Added to the basis of the property acquired.

Caution some closing costs on the sale of business property such as rentals. All expense and income items must be taken on Schedule E. Examples are rental deposits allocations, insurance and tax prorations, prepaid rent allocations and the like.

Since your question pointed at a 1031 exchange, I did not cover the treatment on sale or purchase of real estate held for personal use or dealer property since they do not qualify for 1031 treatment.

Be sure to visit our University web site at <http://www.realtyexchangersuniversity.com> where you will find a lot of great information regarding real estate exchanging and taxation.

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## Contact/Address Change/Removal Information

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**REALTY EXCHANGERS TAX ALERT**

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Edited by James D. Maxwell