Journal of Taxation (WG&L)

SHOP TALK

Conversion of Residential Real Estate to Investment Property for Section 1031 Purposes

This column provides an informal exchange of ideas, questions, and comments arising in everyday tax practice. Readers are invited to write to the editors: Sheldon I. Banoff, Suite 1900, 525 West Monroe Street, Chicago, Illinois 60661-3693, Sheldon.Banoff@kattenlaw.com; Richard M. Lipton, Suite 5000, 300 East Randolph Street, Chicago, Illinois 60601, Richard.Lipton@bakermckenzie.com; and Adam M. Cohen , 555 17th Street, Suite 3200, Denver, Colorado 80202, ACohen@hollandhart.com.

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Gertrude Stein wrote that "A rose is a rose is a rose," often interpreted as meaning "things are what they are." But sometimes a rose is more than that. A rose might be wild, growing on a bush. It might be a boutonniere. It might be a centerpiece on a table. It might be a small expression of love.

Real estate is similar. A plot of land is a plot of land is a plot of land. But sometimes it has a structure on it that is one's personal residence. Sometimes the land is used in a trade or business. Sometimes it is held for investment. Recently issued Ltr. Rul. 201944006 reminds us that sometimes land may change from one purpose to another.

In this ruling, the taxpayer acquired a property (the "Subject Property") to use initially as a principal residence. After a period of time, the taxpayer (with the taxpayer's spouse) moved to a second property to use as their principal residence. The Subject Property was then listed for rent or rented, with some rental being short-term and some being to full-time tenants. The structure on the Subject Property was then destroyed by fire, for which the taxpayers received insurance proceeds. The taxpayers thereafter sold the Subject Property and acquired a third property.

At issue in the ruling was whether the taxpayers could apply Section 121 to the disposition of the Subject Property from the fire and then sale and whether the taxpayers could also apply Section 1031 with respect to the gain on the Subject Property from the sale and the acquisition of the third property. Section 121 provides that qualifying gain from the sale of a taxpayer's principal residence will not be included in gross income. Section 1031 provides that gain or loss from an exchange of property held for productive use in a trade or business or for investment will not be included in income if replaced with property held for such purposes. Thus, at first blush, the two provisions would seem to run contrary to

one another (i.e., for both provisions to apply the property must both have been a principal residence during the relevant time and be held for investment or for use in a trade or business).

In Rev. Proc. 2005-14, 2005-1 CB 528, the IRS addressed whether these provisions could apply simultaneously to the same exchange. There, the IRS considered that Section 121(d)(5)(B) specifically provides that, in the event of an involuntary conversion of property, for purposes of Section 1033, one looks at the gain on the property without regard to Section 121, but reduced by the amount of gain excluded from gross income due to Section 121. In other words, Section 121 applies Section 1033 after the application of Section 121. Likewise, the IRS stated that, if taxpayers satisfy the requirements for both provisions, Section 121 must be applied before applying Section 1031. Ltr. Rul. 201944006 does not break new ground in this regard.

Ltr. Rul. 201944006 applies Rev. Proc. 2005-14 by looking at whether certain requirements of Sections 121 and 1031 are met and leaving other requirements to verification on examination. Specifically, the ruling holds that Section 121 applies and that the taxpayers held the Subject Property for investment.

To determine whether Section 121 applies, the ruling analyzes the ownership requirement and the use requirement. Section 121 requires that, during the five-year period ending on the date of the sale or exchange, the taxpayer owned the property. It also requires that the property was used as the taxpayer's principal residence for two years or more. In the case of married taxpayers filing a joint return, Section 121(b)(2)(A)(i) requires either spouse to meet the ownership requirement and Section 121(b)(2)(A)(ii) requires that both spouses meet the use requirement. Section 121 also contains a maximum benefit, allowing the amount of gain to be excluded to not exceed $250,000 (or, for

married taxpayers filing a joint return, $500,000) and allowing the use of the provision only to one sale or exchange during the two-year period ending on the date of the sale or exchange, which (in the case of married taxpayers filing a joint return) must be applied to both spouses. The IRS found all these requirements were met by the taxpayers that requested the letter ruling by analyzing the relevant dates and amounts.

The IRS then applied Section 121 to the disposition of the structure via the fire and via the sale of the land portion of the Subject Property. Under Reg. 1.121-1(b)(3), these two events are treated as one sale or exchange. Under that regulation, the gain from the sale or exchange of the structure (via the fire and insurance proceeds) used up the maximum benefit under Section 121 first and the gain excluded on the sale of the land was the difference between the maximum limitation amount and the gain excluded on the sale of the structure. Evidently (though not stated in the letter ruling), these taxpayers had gain from the sale of the land that exceeded this excluded gain.

For purposes of Section 1031, the IRS ruled that the Subject Property was held for investment prior to its sale. The only analysis on this point appears to be that the taxpayers represented that they held the Subject Property as investment property during the period it was rented and, after the fire, until the sale.

In *Saunders*, TCM 2002-143, the Tax Court looked at a similar situation. Philip and Elizabeth Saunders, a married couple, bought a house in Pepper Pike, Ohio (a suburb of Cleveland), in 1978 that was exclusively used as their residence (with their children) from 1978 until December 1990. In April 1990, Mr. Saunders took a job in Cincinnati and started spending the weekdays in a rented apartment in Cincinnati, while Mrs. Saunders remained in Cleveland until she found a job in Cincinnati. At the end of 1990 or beginning of 1991, Mr. and Mrs. Saunders moved into a rented house in Cincinnati and then bought a new residence on May 15, 1992.

Meanwhile, the Pepper Pike residence was initially listed for sale in 1991 and then for rent. While the Saunderses did not receive any offers to buy, in September 1991, they rented the Pepper Pike residence for a six-month term, which was extended for an additional six months. The residence then sat empty from October 1992 until it was sold in April 1994. The tax returns reported various expenses associated with the residence and characterized the residence as "held for sale" but the expenses as "deductible rental real estate loss."

The IRS disallowed the rental loss (among other adjustments) and Mr. Saunders, a lawyer working as a consultant for Arthur Andersen, challenged that disallowance. Mr. Saunders represented himself before the Tax Court and argued that the property had been converted from a personal residence to property held for the production of income.

The court instructed that whether a former personal residence has been converted to property held for production of income is a question of fact and must be determined by the surrounding facts and circumstances. The court identified five factors to be analyzed: (1) the length of time the house was occupied by the individual as his residence before placing it on the market for sale; (2) whether the individual permanently abandoned all further use of the house; (3) the character of the property (recreational or otherwise); (4) offers to rent; and (5) offers to sell. None of the factors is to be determinative.

The Saunderses lost their case because the factors were not in their favor. The original intent upon purchase was not for investment or income production; rather, it was to be their residence, which it was for 12 years. When they moved from the house, they intended to sell the property. And, when they could not sell it, the court found that their decision to rent the property was not with the intention to profit from the rental but "to limit the financial burden of owning the Pepper Pike residence." The Saunderses sold the residence at the first opportunity. The court specifically declined to rule that one could convert personal property to held-for-income property merely by renting it for a "temporary" period.

Let's return to Ltr. Rul. 201944006. Given the thorough analysis of Section 121 in the letter ruling, the aforementioned factors, and that the conversion of the Subject Property to a held-for-income property is a facts and circumstance inquiry, one might think that the IRS would provide a robust analysis of this issue. And, while it is possible that the IRS applied these factors in concluding that the Subject Property was held for investment at the time of its sale, the ruling's analysis of the Section 1031 requirements is fairly abbreviated.

The facts in the letter ruling pertaining to the rental of the Subject Property are not laid out in any detail. This makes application of the factors by those reading the letter ruling impossible. The ruling itself does not contain any analysis of the five factors. The taxpayers simply represented that they held the property as investment property at the time of its sale. Readers of this ruling are left to wonder whether the facts applied to these factors would show that the property was converted from a primary residence to investment property.

And, while Section 1031 contains a number of requirements and Rev. Proc. 2005-14 requires all of them be met, the letter ruling only addresses one of those requirements. Aside from accepting the taxpayers' representation that the property was held as investment property at the time of its sale, the ruling specifically expresses no opinion on whether the other requirements of Section 1031 are met.

Overall, it appears that the taxpayers in Ltr. Rul. 201944006 were able to convince the IRS to allow for partial exclusion of gain under Section 121 and to show that the Subject Property was investment property to cover one Section 1031 requirement. So, while a rose may be a rose (or, as Shakespeare put it in *Romeo and Juliet*, "A rose by any other name would smell as sweet"), Ltr. Rul. 201944006 shows that real estate may not just be real estate and taxpayers may successfully savor the sweet smells of gain exclusion under Section 121 and gain deferral under Section 1031 on the same parcel of real estate.

Ed. Note: With this article, the JOURNAL *welcomes Adam M. Cohen, Esq., a Partner in Holland & Hart, LLP, Denver, CO, as co-editor of the Shop Talk Column.*

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