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1) Introduction

In 2010, individual taxes provided almost half (43.35 %) of the U.S. Federal Revenue. Every U.S. citizen has an obligation to pay tax in order to support their government; however, they also have the right to keep tax as low as possible by effective tax planning (Smith, Harmelink, & Hasselback, 2012).

Tax planning is a proper arrangement of transactions or affairs in order to reduce tax liability. Tax planning can become complex if the transaction involves multiple areas of tax law. I am going to discuss an aspect of real estate that involves multiple concepts and rules governing tax compliance: the tax treatment of mixed personal and rental use of real estate.

The paper discusses tax treatment of deductions, losses, sales, and exchanges of mixed-use real estate. Mixed-use real estate means that homeowners rent, or use for business purposes, part or all of their primary or secondary homes, either permanently or temporarily. These situations are pretty common for U.S. citizens yet the tax effects on these transactions are not well understood and can be complex. The focus on the paper is to describe the tax treatment of various situations where residential property is rented at least part of the tax year.

2) Categorization of Tax Type for Residential Property

If the owner of a dwelling unit rents all or part of it out to someone, there are three possible types of tax categorization. The first is personal use, the second is mixed-use, and the last is purely rental use of the dwelling unit. The categorization depends upon the number of days of personal use and rental use, and the categorization affects deductibility of an owner's expenses on a dwelling unit and rental losses. The tax law limits deductibility of expenses and losses of personal use of a dwelling unit although it provides more generous rules for rental use. Therefore, proper tax categorization is the first and the essential element to understand further tax rules for this paper.

(A) Personal Use Real Estate Defined and Illustrated

Categorizing real estate depends on how a dwelling unit is used, either for personal, business, and/or investment purposes. A dwelling unit is a basic living accommodation equipped with plumbing, a kitchen, sleeping facilities and a living area. In the tax sense, the personal use of a dwelling unit can include uses other than the taxpayer living in the dwelling personally. A taxpayer also uses a dwelling for personal purposes if the taxpayer rents the dwelling to a friend or family member for a less than market value. It is also personal use if an owner rents out his or her personal residence for only a small number of days. The lax law states that it is still personal use when a taxpayer rents out his or her personal residence less than 15 days during a tax year. When the residence is rented less than 15 days, the taxpayer is not required to report the rental income and may not deduct any rental expenses other than mortgage interest (if it is qualified residence) and property taxes as itemized deductions. Code Sec.280A (g) (2).

The following are all examples illustrating personal use of a dwelling unit:

Example 1: Adrian rents his residence to his sister. He tells her that she only has to pay half of the fair rental price.

Example 2: Adrian exchanges the right to use his vacation home for the use of Mellissa's beach house. Mellissa's use of Adrian's vacation home under this arrangement is considered Adrian's personal use of his vacation home from a tax planning point of view.

Example 3: Adrian rents out his personal residence for Alex. Alex stayed 14 days at the basement of Adrian's resident and paid $100 for the rent.

A dwelling unit can have more than one owner. If two or more people invest in one dwelling unit it is considered joint ownership of the property. Even if only one of the owners uses the dwelling unit for personal use, it is considered personal use of the dwelling for the remaining joint owners.

Example 1: Adrian and Jerry bought a duplex as joint owners by dividing the cost of the duplex. Adrian lives in one of the units part of the year. This is considered personal use of half of the duplex.

If the owner rents out his property and discovers it needs maintenance, the property is not considered personal use during the time of repair. Code Sec. 280A (d).

Example 2: If Adrian spent two days fixing leaking pipes of his dwelling unit for a new tenant, these two days are not included as personal use of the property.

(B) Mixed-Use Real Estate Defined and Illustrated

Mixed-use of real estate involves renting a dwelling unit at market value and also using it for personal purposes. If an owner of a dwelling unit uses his or her dwelling unit more than the greater of (1) 14 days or (2) 10% of rental days, then the dwelling unit is categorized as a personal residence. If the owner also rents out the residence for more than 14 days, the residence is classified as mixed-use. These examples illustrate mixed-use real estate.

Example 1: Adrian rents part of his residence to his sister for six months. She pays fair market value.

Example 2: Adrian rents his vacation home to Mellissa. He uses the home two weeks for winter vacation. Mellissa uses the home for one month for summer vacation and pays fair rental price to Adrian.

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(C) Rental Real Estate Defined and Illustrated

Residential rental activity occurs when there isn't significant personal use under the tax rules. If an owner of the dwelling unit rents out the dwelling unit for more than 15 days for market value and he or she does not use it for a personal purpose, then it is rental use for tax categorization. Significant personal use occurs if the rental property is used for personal purposes more than the greater of 14 days or 10 % of the days rented. Code Sec. 280A(d). These examples illustrate pure rental use of real estate.

<u>Example 1</u> : Adrian rents out his second home to the Adams family at fair market value.

<u>Example 2</u> : Adrian rents out his vacation home to Alex for fair market value for 200 days. He also used his vacation home for 1 week.

<u>Example 3</u> : Adrian and Jerry bought a duplex as joint owners and they divided the cost of the duplex. They rent out one of the units at market value for a whole year to the Adams family. This type of rental use is considered rental activity of half of the duplex.

It is important to distinguish between personal use and rental use for tax planning since tax treatment differs between categories. For example, an owner cannot deduct any maintenance costs from taxable income for a personal use dwelling unit, whereas the owner can deduct the maintenance costs from taxable income for a rental property.

One common way to reduce tax liabilities is through effective use of tax deductions. Tax deductions are subtractions from income used to calculate the eventual taxable profit from the activity. There are four categories of deductions for tax payers. The four categories include: (1) Trade or business, (2) Production of income, (3) Personal expenses, and (4) Losses (Smith, Harmelink, & Hasselback, 2012).

3) Types of Deductions for Individuals under the Tax Law

(A)Trade or business expenses (Code Sec. 162)

Trade or business expenses for individual taxpayers include the business-related expenses of sole proprietors and employees. Trade or business expenses are ordinary, necessary and reasonable expenses that are deducted from any income of the taxpayer.

<u>Example:</u> Adrian owns a business and he expended $30,000 for his business. His income from his business for the year was $25,000. He also had interest income of $10,000 and dividend income of $5,000. The $30,000 of business expenses first reduce business income but if business expenses are more than business income, the excess can also reduce taxable income from other

sources. Adrian's adjusted gross income after taking the expenses would be $10,000.

3-A	**Business**	**Interest**	**Dividend**	**Total**
Income	$ 25,000	$ 10,000	$ 5,000	$ 40,000
Expenses	$ 30,000			$ 30,000
Adjusted Gross Income				$ 10,000

(B) Expenses Incurred For the Production of Income (Code Sec. 212)

Expenses incurred for the production of income includes investment related expenses and rental expenses. The deductible expenses for this category must relate to the production or collection of income, or in other words, the expenses necessary to produce profit. The expenses incurred for the production of income include management, maintenance, collection of income, and determination of tax payments or refunds. While rental expenses are directly deductible from rental income, most production of income expenses are deducted as itemized deductions and are subject to more restrictions on the ability to use them as deductions against other taxable income. The tax law limits the deductibility of miscellaneous itemized deductions. Depending upon a taxpayer's adjusted gross income, expenses of this category may not be deductible or only partially deductible. This example shows deductibility of production income expenses.

<u>Example - Production of Income:</u> Allen has some securities as an investor and his investment expenses are $3,000 for this year. His income from his investment activity for the year was $2,500, and his wage income was $30,000. His investment expenses can be deducted from his miscellaneous itemized deduction up to his investment income.

3-B	**Investment**	**Wage**	**Total**			**Deducable Itemized Expenses**		
Income	$ 2,500	$ 30,000	$ 32,500			**Investment Expenses**		$ 3,000
Adjusted Gross Income			$ 32,500			**2% floor**	(32500x2%)	$ (650)
Itemized Deduction			$ 2,350					$ 2,350
Taxable Income			$ 30,150					

Note: Rental expenses are reported on Schedule E and deducted directly from the rental income.

(C) Personal Expenses (Code Sec.262)

Personal expenses are those a taxpayer spends for personal or family needs and almost none are deductible for tax purposes. Generally an owner of a residential home can only deduct the related personal expenses of qualified mortgage interest and property taxes on the property.

Home mortgage interest is any interest a taxpayer pays on a loan secured by his or her home, including mortgage, home equity loans, points, and mortgage insurance premiums. A taxpayer can deduct his or her home mortgage interest only if the mortgage is a secured debt. A mortgage is a secured debt if a taxpayer puts his or her home up as collateral to protect the interest of the lender. Hence, when a taxpayer defaults on his obligation to the lender, his or her home will serve as payment to the lender. Those expenses are deductible only for qualified homes. Code Sec. 163 (h) (3).

A qualified home is a main home and a second home. A taxpayer must use these homes more than 14 days or more than 10% of the number of days during the year that the home is rented at a fair rental, whichever is longer. Code Sec. 163 (h) (4).

Acquisitions indebtedness is an outstanding amount owed on a loan as a secured debt taken out for purpose of acquisition, construction, or substantial improvement of qualified residence, it is deductible up to $1,000,000. Code Sec. 163 (h) (3)(B).

Home equity loans are a type of loan; a homeowner borrows money by leveraging the equity in his or her home. A taxpayer can deduct the interest that is the lesser of $100,000 or fair market value subtracting acquisition indebtedness in the home. Code Sec. 163 (h) (3)(C).

Points are prepaid interest to obtain a home mortgage. They may be deducted in the year paid unless they are added to the loan balance. The IRS takes the view that points paid on a mortgage refinancing are deductible ratably over the life of the mortgage.

Mortgage insurance premiums are insurance premiums paid by a taxpayer in order to acquire a mortgage when the taxpayer's down payment is insufficient (typically less than 20% of the value of the residence). The allowable deduction is phased out ratably when the taxpayer's adjusted gross income exceeds $100,000 ($50,000 for a married taxpayer filing separately). Code Sec. 163(h)(3)(E).

Property taxes include local, state, and foreign real property taxes. These must be imposed on the value and be paid or accrued. If the tax is paid for local benefits (also called special assessments), then the payment is not deductible because of direct benefit to the property. Examples of this kind of payment are street and sidewalk improvements. Code Sec. 164 (a) and (c). These types of special assessments are normally added to the basis of the property.

Expenses of a residential property other than mortgage interest and property taxes are normally not deductible unless the property is a bona fide rental property. Code Sec. 280A (a). Bona fide means in rented in good faith and without fraud or deceit. If the property is a rental property, rental expenses are deductible for Adjusted Gross Income on Schedule E.

4) Deduction for Losses

Losses can occur when a property is sold for less than the taxpayer's investment (basis), when operating expenses exceed income, or as the result of casualties and theft. A loss can be categorized one of three types for tax purpose:

A. Business losses

B. Investment/Production of income losses
C. Personal losses

(A) Business Losses are losses incurred in trade or business activities. In general, those losses are deductible from any types of income, thus a taxpayer is able to reduce his/her gross income by the amount of these losses. Code Sec. 172.

(B) Investment or Production of Income Losses consists of rental and investment activities.

Investment income and expenses consist of those relating to interest income, dividends, capital gains or losses incurred upon the sale of a security or other assets, and any other profit or losses that is made through an investment. Rental income and expenses are also considered investment related but rental expenses are deducted from rental expenses in arriving at adjusted gross income instead of being relegated to the less desirable status of miscellaneous itemized deductions. Rental operating losses may or may not be deductible depending upon whether the taxpayer satisfies certain requirements for deducting losses under the passive activity rules.

Rental activities are usually subject to Passive Activity Rules. Code Sec. 469, the Passive Activity Loss Rules, address two types of activities:

> 1-Trade or business activities in which a taxpayer <u>does not materially participate</u> during the tax year;
>
> 2-Rental activities, with or without material participation, which includes rental real estate.

The trade or business activities are not a passive activity when the taxpayer materially participates in the activity. Reg §1.469-5T. Material participation is defined at IRC Sec.469 (h). When the taxpayer's activity satisfies material participation standards, the activity is treated as a trade or business instead of a passive activity. However, the normal rules for material participation rule are not applicable to rental activities. Code Sec. 469 (c) (4).

According to the tax law, real estate held by an individual taxpayer that is used by renters is usually categorized as a passive rental activity. There are a few exceptions where rental real-estate activities are not categorized passive activities. These are the trade or business uses such as hotels or motels. Another important exception falls under Code Sec.469 (c)(7) describing exceptions from the passive activity rules for rental real estate held by a real estate professional, Fed. Reg. Vol. 77, No. 234, p. 72611. 12/05/2012. Finally, rental real estate that is also used substantially for personal purposes (as described above) is not treated as bona fide rental property.

Tax law limits the amount of a taxpayer's deductible loss of passive activity. Normally, a taxpayer can deduct passive activity losses only from passive activity income. When the expenses of passive activity exceed the income of passive activity, then a taxpayer can carry forward deductions to future years, but those losses face the same deduction restrictions in future years. This example shows deductibility of passive activity losses (Smith, Harmelink, & Hasselback, 2012).

> Example: If the previous year Alex had rental losses of $8000, he would carryover the losses. If he now has $10,000 in rental income, he can deduct the carryover expenses from the current income. However, if his rental income of the current year is zero and he has other sources of income, he cannot deduct the carryover losses from other types of income.

4-B Sec469				
Fiscal year 1 (FY1)	**Rental**	**Interest**	**Dividend**	**Total**
Income	$ 2,000	$ 10,000	$ 5,000	$ 17,000
Expenses	$ 10,000			$ 2,000
Taxable Income				$ 15,000
Carryover for future year	$ 8,000			
Fiscal year 2				
Income	$ 10,000	$ 10,000	$ 5,000	$ 25,000
Expenses	$ 3,000			$ 3,000
Carryover from FY1	$ 8,000			$ 7,000
Taxable Income				$ 15,000
Carryover for future year	$ 1,000			

Rental expenses + Carryover are deductible up to rental income, thus the rest of $1,000 will be carried over to future years.

Code Sec. 469 (i) (6) provides a special allowance for active participation of a rental real estate activity. When a taxpayer or his or her spouse actively participated in a rental real estate activity, then a taxpayer can deduct up to $25,000 of loss from non-passive activity income. A taxpayer is an active participant when a taxpayer owns at least 10% of the rental activity and is the landlord maintaining general management responsibilities such as approving new tenants, or deciding on rental terms. However, there is an income limitation for this allowance. When a taxpayer's adjusted gross income without considering the rental loss (and certain other income like taxable social security benefits as well as certain other deductions) exceeds $100,000 the allowance is reduced by 50% of the AGI exceeding that amount. Therefore, a taxpayer with $150,000 AGI is not able to use rental losses as a deduction against non-passive income. These two examples show the differences of special allowance application by income level.

> Example 1: Alex is single and has $40,000 wage income, $2,000 passive income, and $3,500 of passive expense from his rental real estate activity. He actively participates in his rental activity, thus after he offsets the passive income to passive expenses, he can

offset the residual passive loss of $1,500 from wage income. As a result, he is able to reduce his adjusted gross income from $40,000 to $38,500.

4-B Sec469(i)				
Example1		**Wage**	**Rental**	**Total**
Income		$ 40,000	$ 2,000	$ 42,000
Expenses			$ 3,500	$ (2,000)
Losses			$ (1,500)	
A Special Allowance				$ (1,500)
Taxable Income				$ 38,500

Example 2: Adrian is single and has $140,000 wage income, $2,000 passive income, and $8,500 of passive loss from his rental real estate activity. He actively participates in his rental activity, but his adjusted gross income is $140,000. After he offsets the passive income to passive loss, he can only offset the residual passive loss of $5000 from wage income. As a result, he lost 80% or $20,000 of special allowance caused by a high level of income.

4-B Sec469(i)									
Example 2		**Wage**	**Rental**			**Special Allowance Calculation**			
Income		$ 140,000	$ 2,000			**Wage**		$	140,000
Expenses			$ 8,500			**Phase out range**		100,000-150,000	
Losses			$ (6,500)			**Phase out %**		40,000/50,000=80%	
A Special Allowance		$5,000				**Allowance**		5,000=25,000 x 20%	
Taxable Income		$ 135,000							
Carryover			1,500						

(C) The last type of loss is a **personal loss**. Personal losses include selling personal use property for less than basis (the taxpayer's original cost or remaining investment in the property), losses by casualty or theft of personal use property, and operating losses from hobby activities that provide some income. A loss on the sale of a personal residence (as defined above) would also produce a personal loss. Generally the tax law does not allow deductions of personal losses from taxable income. Therefore, rental expenses are only allowed up to the rental income when the property is used excessively for personal purpose as in the mixed-use status as described above. Code Sec. 165 (c).

Example: Alex bought his residential home for $220,000 5 years ago and he decided to sell it for money for his operation. He sold it for $190,000. He cannot deduct the loss of $30,000.

Example: Alen used his vacation home for two months for his winter vacation. He also rented it for fair rental value to Adam's family for two months for their summer vacation. He collected $1,500 from the family and spent $1,700 for cleaning, maintenance, and advertising. He cannot deduct the loss of $200 because he used the property excessively for personal purpose.

Exception for non-deduction of personal losses is casualty or theft losses. However, the deductibility of the losses is severely limited. Code Sec. 165 (h).

The categorization of activities has a huge impact on the tax treatment of expenses and losses. However, many individual taxpayers use their real estate for both rental and personal uses. Because of this, its tax treatment becomes more complex.

5) Allocation of Deductions on Mixed-use Real Estate

When a taxpayer uses his real estate more than the greater of (1)14 days or (2) 10% of rental days, then it is categorized as a personal residence. However, if at the same time he rents out the residence for more than 14 days for fair market value, then the dwelling is considered as mixed-use. In other words, the real estate was used a lot for a personal purpose and a rental purpose. The expenses of mixed-use real estate are allocated between rental and personal. Some tax deductions can be used only for rental purposes while others (like mortgage interest and property taxes) may be deducted for both purposes. Compare these examples (Publication 527,P.23)

Background: Alex Brown rents a cabin for part of the year. The mortgage interest on the cabin is $10,000. If it were rented for 100% then its depreciation expenses would be $7,000. Property taxes for the cabin are $2,000, plus other expenses in sum of $2,000.

Example 1: Alex lived in the cabin for 31 days and he rented it for only 12 days. He received $1,000 for rental fees.

Since he rented less than 14 days, this is not mixed-use real estate. Alex does not have to report the income as well as no deduction for expenses. However, he can deduct the mortgage interest and property taxes from his Schedule A as itemized deductions allowable for a personal residence.

Example 2: Alex lived in the cabin for 10 days and rented it for 90 days. He received $7,000 for rental fees. Under these circumstances, the property would be classified as a rental property because Alex lived in the cabin for less than 14 days. He must allocate his expenses between personal and rental use. Only his property taxes are deductible for personal purposes because this property does not qualify as a second residence for purposes of the mortgage interest deduction (needs to live in the property for at least 14 days). The rental expenses may exceed the rental income, but whether any loss is deductible depends upon the application of the passive activity rules as described above.

Alex can report the portion of rental expenses on Schedule E as deduction used in arriving at adjusted gross income. For mixed-use property, rental deductions can only be taken up to rental income.

5) Example 2	Total	Rental	Personal
Days	100	90	10
Income	$ 7,000	$ 7,000	
Expenses			
Allocation	365	0.25	0.75
Mortgage	$ 10,000	$ 2,466	
Prop. Taxes	$ 2,000	$ 493	$ 1,507
Allocation	100%	90%	10%
Depreciation	$ 7,000	$ 6,300	
Other	$ 2,000	$ 1,800	
Total Expenses	$ 21,001	$ 11,059	$ 1,507
Deductable Exp for the year (***)		$ 7,000	$ 1,507
Carryover		$ 4,059	

Mortgage & Property taxes are allocated as personal use for the total days of the year minus the rental days of the year.

Since personal use is less than 14 days, this residence does not qualify for the mortgage interest deduction.

*** Alex's deductible expenses would range from $7,000 to the full $11,059 depending upon the application of the passive activity rules. This example shows the calculation when passive activity is applied.

<u>Example 3</u>: A mixed-use of real estate. Alex lived in the cabin for 25 days and rented it 90 days during the tax year. He received $7,000 for rental fees.

He needs to allocate his expenses between personal use portions of expenses and rental use expenses. IRC Sec 280A (e)(1).The rental portion of expenses is deductible in Schedule E .

5) Example 3	Total	Rental	Personal
Days	115	90	25
Income	$ 7,000	$ 7,000	
Expenses			
Allocation	365	0.25	0.75
Mortgage	$ 10,000	$ 2,466	$ 7,534
Prop. Taxes	$ 2,000	$ 493	$ 1,507
Allocation	115days	78%	22%
Depreciation	$ 7,000	$ 5,460	
Other	$ 2,000	$ 1,560	
Total Expenses		$ 9,979	$ 9,041
Deductable Exp for the year		$ 7,000	$ 9,041
Carryover		$ 2,979	

The deductible and carryover amounts in Examples 2 and 3 are far different even though rental income and expenses are the same because of the amount of personal use days.

6) Sales and Exchanges of Mixed-use Real Estate

A sale occurs when an owner of the property exchanges real estate for cash or other property. Other property may include the buyer's assumption of liabilities which is treated the same as receiving cash.

Rental use of real estate is property used for investment purposes. When a rental property is sold, its gains and losses are recognized for tax purposes.

When a taxpayer's residential property was used for part personal and part rental, the gains from the sale of the property should be allocated between personal and rental. The personal portion of gain may be excluded but the rental portion of gain must be recognized. The structure of real estate affects the allocation method for gain and loss of sales. Rev. Proc. 2005-14.

(A)Code Sec. 121 allows a taxpayer to exclude the gain from sale of his or her principal residence up to $250,000 ($500,000 for joint return). To be qualified, the taxpayer must own and use the property as his or her principal residence for at least 2 years during the 5-year period, ending on the date of the sale or exchange. The taxpayer must also have no transactions that apply to the $250,000 exclusion for at least two years.

<u>Example</u>: Adrian sold the principal residence that he lived in for 7 years. After the deduction of his sales expenses, his profit from the transaction was $210,000. He can exclude this profit from his income for tax filing because this transaction is a qualified residence and his profit is under the $250,000 limit. If he purchases another principal residence for $210,000, that will be the cost basis of the new residence.

When a taxpayer realizes the losses from sale of his or her principal residence, the losses are not allowed to be deducted from his taxable income.

Under the Sec.121, a taxpayer who used a portion of a property for residential purpose and a portion of the property for business or rental purposes is treated as using the property as the taxpayer's principal residence if it satisfying the 2 year use requirement. When this kind of sale occurred, the taxpayer may exclude most gain from realized gain but he or she still has to recognize the gain to the extent of any depreciation taken. The gain exclusion under Sec.121 doesn't include gain resulting from previous depreciation deductions. Rev. Proc. 2005.

Depreciation is the term for expensing the cost of a long-term asset over its useful life. Depreciation expenses reduce profits from the activity using the property. The owner of the property can deduct depreciation only on the part of his or her property used for rental purpose.

Sec. 121 is applicable only for personal use of real estate; therefore depreciation is not deductible under Sec.121.

(B) If a taxpayer acquired the relinquished property during a five year period from on the date of like-kind exchange (explained below), he or she cannot apply Sec 121 exclusion when he or she sold the real estate within the period. Rev. Proc. 2005. A taxpayer trades the rental or business property for other property of similar type that qualifies as "like-kind" under **Code Sec. 1031**. Like-kind treatment under Section 1031 allows the taxpayer to delay or not recognize the gain from the transaction. However, an exchange involving personal use property does not qualify for this purpose.

Example: Adrian exchanged his rental apartment for Alex's rental house. The exchange is the same business class and function, so it is a like-kind exchange.

Example: Adrian exchanges his rental apartment for Alex's residential house. If Adrian uses the residential house for rental purpose, he is qualified for non-recognition of gain treatment under Section 1031. However, if Adrian uses the house for personal residence then the exchange is not like-kind and the gain from his former rental property must be recognized.

When a taxpayer exchanges his or her rental property for like-kind property and boot, he or she may recognize gain. Boot is cash or cash equivalent, stock, inventory and other property not of a similar type as stated under Code Sec. 1031 (a) (2). Gain is recognized to the extent of the lower amount of

A- The fair market value of the boot received or
B- The realized gain on the transaction

A realized gain is the difference between the amount realized from the sale or other disposition of property and the adjusted basis at the time of sale or disposition. In other word, the gain resulting from the sale price of an asset exceeds its purchase price or adjusted basis. The realized gain is not necessarily taxable. However, when fair market value of like-kind property and boot received are less than adjusted basis of property given up, the losses cannot be recognized.

(C) Combination of Code Sec. 121 and 1031

When a taxpayer sells real estate which was used for both personal and rental use, there is the possibility that the single transaction would meet both gain exclusion under Code Sec. 121 and non-recognition of gain under Code Sec. 1031. This type of treatment would occur when mixed-use property is exchanged for a similar mixed-use property. For example, a person uses two floors of a single house for different purposes. The first floor is used as the office space for her business and the second floor is used for her residence. She exchanges this property for another property of similar use. She could have this type of exchange for a property of similar but somewhat different use. One example is that, she exchanges the property for a motel or bed and breakfast house where she lives in part of the structure and rents the other rooms.

The Internal Revenue Service specifies the procedure of accounting for this type of transaction, and the allocation depends on the usage and nature of the real estate. When a taxpayer used real estate for a period of personal use and another period of rental use, and the transaction meets both requirements, the taxpayer should apply Code Sec. 121 first. However, when a taxpayer uses real estate for personal and rental purposed simultaneously, then he or she should allocate the gain between personal and rental use. Rev. Proc. 2005-14.

One way to allocate the profit is to first deduct the excludable gain under Section 121 (up to $250,000 for unmarried or up to $500,000 for married joint taxpayers) from the total gain and apply the deferral opportunity under Section 1031to the remainder of the gain. A taxpayer who used the property as personal in a certain period of time and then rented it in another period of time should use this method. A taxpayer used one dwelling unit for mixed-use the same time of period also fits in this method. Rev. Proc. 2005-14.

Example 1: Adrian exchanged his condo for a townhouse for a rental purpose with a fair market value of $440,000. He used the condo for his principal residence for 2 years and then rented it for 3 years. He bought the condo for $240,000 in 2000. He claimed depreciation for $30,000 from 2011 to 2013.

Bought and Used		**Period of year**	**Gain Allocation**	**Apply Sec 121**
Bought for residnce	$ 240,000	2	0.4	$ 96,000
Conv. To Rental				
Depreciation	$ 30,000	3	0.6	
Basis at the end of 2013	$ 210,000	5	1	
Exchange it for fair value	$ 480,000			
Gain from the exchange	$ 270,000			
Attribute to Depreciation	$ 30,000			
Gain 121. defenition	$ 240,000			
Excludable Gain 121	$ 96,000			
Residual Gain	$ 144,000			
Attribute to Depreciation	$ 30,000			
Delay Recognition 1031	$ 174,000			

Since he used the house 2 years during the 5 year period ending with the transaction, he is eligible for both Code Sec. 121 and 1031 on his gain. First he applies Code Sec.121 for his realized gain of $270,000 minus depreciation taken, then calculates the portion of the gain which is applicable to Sec. 121 gain exclusion by total number of days used for his principal residence divided by total days that he owns the condo. The remaining gain of $174,000 then applies for Sec. 1031, as a result Adrian has no recognized gain. RIA ¶104, Code Sec. 121(b)(4).

Example 2: Alex exchanged his townhouse for a duplex with a fair market value of $360,000. He rented one room of the townhouse for fair market value and used the remainder for his principal residence for 5 years. He bought the townhouse for $210,000 and it depreciated $30,000. Alex allocated 1/3 of the basis the townhouse for rent and 2/3 for his principal residence. His townhouse was a single dwelling unit.

Year		**Total**	**Residence**	**Rental**
		100%	2/3	1/3
2000-2004	**Bought and Used**			
	Cost	$ 210,000	$ 140,000	$ 70,000
	Depreciation	$ 30,000		$ 30,000
	Basis	$ 180,000	$ 140,000	$ 40,000
2005	**Exchange**			
	Fair Value	$ 360,000	$ 240,000	$ 120,000
	Basis	$ 180,000	$ 140,000	$ 40,000
	Realized Gain	$ 180,000	$ 100,000	$ 80,000
	Sec. 121	$ 150,000	$ 100,000	$ 50,000
	Residual gain	$ 30,000	$ -	$ 30,000
	Sec. 1031	$ 30,000		$ 30,000

Since Alex used one dwelling unit for rental and personal purpose, the realized gain should be applied for Sec. 121 first. However, gain exclusion Sec. 121 does not take depreciation.

Another method is to allocate the profit proportionally. When a taxpayer used a dwelling unit for his or her primary residence and he or she rented a dwelling unit that is separate from the other dwelling unit, then profit should be allocated between Code Sec 121 and 1031 proportionally. Rev. Proc.2005-14, RIA¶1214.06. A single structure may contain more than one dwelling unit if it has multiple apartments each used as separate dwelling units. If the basement of a house contained basic living accommodations, it would be a separate dwelling unit. Prop. Reg §1.280A-1(c)(1), Reg. §1.121-1, RIA EXP¶280A4.07.

Example 3: The facts are the same as in Example 2 except Alex's townhouse consists of two dwelling units.

Year		Total	Residence	Rental
		100%	2/3	1/3
2000-2004	**Bought and Used**			
	Cost	$ 210,000	$ 140,000	$ 70,000
	Depriciation	$ 30,000		$ 30,000
	Basis	$ 180,000	$ 140,000	$ 40,000
2005	**Exchanged**			
	Fair Value	$ 360,000	$ 240,000	$ 120,000
	Basis	$ 180,000	$ 140,000	$ 40,000
	Realized Gain	$ 180,000	$ 100,000	$ 80,000
	Sec. 121		$ 100,000	
	Resedual gain			$ 80,000
	Sec. 1031			$ 80,000

Since the townhouse consists of two dwelling units, he allocates the gain between residential and rental proportions under Sec. 121 and Sec. 1031, applied respectively. Sec. 121 applies only the proportion of residential use or 2/3 of gain, and Sec. 1031 applies only for the 1/3 of the rental portion.

(D)The Basis of Real Estate Property

The basis of residential property is usually “cost basis”, that is the purchase price plus some capitalized costs at the time of purchase. For the rental property, basis is calculated by costs plus increases for improvement minus depreciation deductions and any losses taken on the property (for example, partial casualty losses or losses from partial condemnations by governmental agencies). The mathematical result is called “adjusted basis.”

The basis of like-kind exchanged property is “carryover basis”.

Carryover basis = like-kind property exchanged + boot given + gain recognized – loss recognized – fair market value of boot received.

When a mixed-use of property with Code Sec. 121 and 1031 apply, the determination of the basis of the property received in the exchange is used in the replacement rental or business property. Although the gain excluded under Code Sec. 121 does not have to be recognized, any excluded gain is added to the basis of replacement property. If a taxpayer does not include it in the replacement basis, then he or she will have a lower basis of new property and will have to deal with the gain when he or she sells or exchanges the new property in the future. The residual gain increases the replacement business property by adding the basis of exchanged property. Rev. Proc. 2005-14, 2005-1 CB 528.

<u>Example 1</u>: Adrian exchanged his condo for $10,000 of cash and a townhouse with a fair market value of $470,000. He intends to use the townhouse for a rental activity. Adrian used his condo

for his principal residence for 2 years and then rented it for 3 years. He bought the condo for $240,000. He claimed depreciation of $30,000.

		Gain	**Carryover basis**
Like-kind exchange	$ 470,000		
Cash (Boot)	$ 10,000		$ (10,000)
Amount realized		$ 480,000	
Cost of Aprtment	$ 240,000		
Depreciation	$ 30,000		
Adjusted basis		$ 210,000	$ 210,000
Realized Gain		$ 270,000	
Less: Sec.121		$ 240,000	$ 240,000
Gain to be defrred Sec 1031		$ 30,000	
Gain to be recognized		$ -	
Basis in the replacement property			$ 440,000

Adrian allocated the gain to Sec 121 at first, because he converted residential use to rental use for a dwelling unit. He received cash as boot but it is included in Sec 121, so he recognized no gain the year of exchange. However, the gain excluded under Sec. 121 should be included in the carryover basis for his received property.

Example 2: Alex bought a house for $360,000; the house consists of two separate dwelling units. He used one dwelling unit of the house as his principal residence for 5 years. He rented the other dwelling unit of the house for fair market value. The allocation of the costs and expenses is 2/3 for him and 1/3 for the rental unit. He claimed $50,000 for depreciation during the 5 years. Then he exchanged the house for a $660,000 duplex. He uses one side of the duplex for his principal residence and rents the other side.

	Total	Residential		Rental		
	1	2/3		1/3		
Like-kind exchange	$ 660,000	$ 440,000		$ 220,000		
Cash	$ -					
Amount realized	$ 660,000		$ 440,000		$ 220,000	
Cost of Aprtment	$ 360,000	$ 240,000		$ 120,000		
Depreciation	$ 50,000			$ 50,000		
Adjusted basis			$ 240,000		$ 70,000	
Realized Gain			$ 200,000		$ 150,000	
Less: Sec.121			$ (200,000)		0	
Gain to be defrred			0		$ 150,000	
Gain to be recognized			0			
Basis in the replacement property			$ 440,000		$ 70,000	

Since the rental portion of the gain is excluded under Sec.121 and Alex receives no boot and has recognized no gain or loss in the exchange, his basis of rental property is the adjusted basis of the relinquished rental property.

Conclusion

This paper was intended to serve as a guide to the tax treatment of deductions, gains, losses, and exchanges involving mixed-use real estate. The tax law has specific definitions for each word and phrase and those definitions need to be understood in order to apply the tax laws. The categorization of transactions helps us understand which rules to follow, but some transactions involve more than one set of categorical rules and that complexity makes proper compliance more difficult and time consuming.

Tax law is changing constantly in response to economic and political change. This paper refers to 2013 tax law, and the rules and numbers above may be modified in the future. A tax practitioner is responsible for researching and applying appropriate and up-to-date tax law. I hope this paper provides some insight into a commonplace yet complex area of the tax law and helps readers appreciate the importance of tax planning.

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Interest. Internal Revenue Code §163

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Expenses for production of income. Internal Revenue Code §212

Personal, living, and family expenses. Internal Revenue Code §262

Disallowance of certain expenses in connection with business use of home, rental of vacation homes, etc. Internal Revenue Code §280A

Passive activity losses and credits limited. Internal Revenue Code §469

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