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Tax Law

Alert

Tax Court Rules on Investment and Residential Real Estate Transactions

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The Internal Revenue Code (the "Code") contains several practical provisions designed to reduce or eliminate income tax liability in certain real estate transactions. Code § 1031(a) provides that no gain or loss shall be recognized on like-kind exchanges, which it defines as exchanges of (1) property held for investment purposes or for productive use in a trade or business for (2) property that will also be held for investment purposes or for productive use in a trade or business. While Code § 1031 concerns investment or business-related property, Code § 121 provides tax relief on the sale of a taxpayer's residence. Code § 121(a) permits taxpayers filing a joint return to exclude $500,000 of gain on the sale of property used as the taxpayer's principal residence for two of the last five preceding years. The Tax Court has applied each of these taxpayer relief provisions in two recent cases.

Goolsby v. Commissioner, T.C. Memo. 2010-64

A taxpayer who holds resort or vacation property and complies with the requirements of Code § 280A(d) is deemed to hold such property as investment property, making it eligible for a non-taxable exchange under Code § 1031. Many taxpayers who hold such property have considered exchanging it for another resort or vacation property and then, upon retirement, occupying the replacement property as their principal residence. For these exchanges, the question under Code § 1031 is how long must the taxpayer hold the replacement property as an investment before occupying it as a principal residence in order to preserve non-taxable treatment as a like-kind exchange. A recent case, *Goolsby v. Commissioner,* T.C. Memo. 2010-64, speaks to this issue.

In *Goolsby*, a husband and wife living in California owned a principal residence and a single-family residence held for investment purposes. Mr. Goolsby signed a purchase agreement for a property in Fayetteville, Georgia, which was contingent upon the sale of his personal residence. Mr. Goolsby then signed an agreement to sell his investment property and assigned the contract of sale to a qualified intermediary to conduct a deferred like-kind exchange pursuant to Code § 1031. The investment property was sold, and the net proceeds were paid to the qualified intermediary.

Following the sale, Mr. Goolsby directed that the proceeds held by the qualified intermediary be used to purchase the property in Fayetteville, Georgia. Mr. Goolsby then attempted to rent the Georgia property by placing an advertisement in a neighborhood newspaper. Notably, Mr. and Mrs. Goolsby failed to inquire whether their neighborhood association would allow them to rent the property. After failing to rent the property for only two months, Mr. and Mrs. Goolsby moved into the replacement property and occupied it as their principal residence.

The court began its analysis by reciting the language of Code § 1031(a) that allows a non-taxable exchange of investment property solely for property of a like kind that is to be held as investment property. The court found that Mr. and

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Mrs. Goolsby complied with the requirements of Code § 1031 for a deferred like-kind exchange—the property was identified and received within the prescribed time limits, and a proper qualified intermediary was used. The issue, however, was whether the replacement property was held for investment purposes. The court found that a taxpayer's intent to hold replacement property for investment is a question of fact that must be determined at the time of the exchange. Further, taxpayers bear the burden of proving that they possessed the requisite investment intent. The investment intent must be the taxpayer's primary motivation for holding the exchanged property if the property is to be treated as held for investment under Code § 1031. The use of property solely as a personal residence is antithetical to its being held for investment purposes.

The court held that the taxpayers failed to meet their burden of proof that the replacement property was held for investment at the time of the exchange. The court cited the petitioners' move into the property within two months after it was acquired and Mr. Goolsby's inquiry of the qualified intermediary whether petitioners could move into the replacement property if tenants could not be found. The court found this to be evidence of intent to occupy the property as a personal residence before it was purchased. The court also noted that the petitioners began renovations on the replacement property to modify it for their personal use within two weeks after the purchase.

The court found that the taxpayer's attempts to rent the replacement property were minimal and not persuasive as to taxpayers' intent to hold the property for investment purposes. In summary, the court concluded that petitioners failed to meet the burden of proof that, at the time of the exchange, their primary purpose in holding the replacement property was for investment purposes. Consequently, the sale of the original investment property was a taxable event, resulting in a tax deficiency for the petitioners and an understatement penalty pursuant to Code § 6662(d)(2)(A).

Following *Goolsby*, there is some question as to the safest course of action with respect to replacement property involved in a Code § 1031 exchange. If the property actually was rented and that activity continued for a significant and uninterrupted period of time (e.g., two years), the investment intent would clearly be established at the time of the exchange. By contrast, if the resort property had only a seasonal rental period, such as the summer months, advertising it for rent through the winter would not provide a strong case for investment intent. While the court in *Goolsby* correctly cited *Bolker v. Commissioner,* 81 T.C. 782, which held that the taxpayers' intent to hold a property for investment is a question of fact that must be determined at the time of the exchange, facts that are consistent with that intent following the exchange offer the most persuasive argument. Though there is no bright-line rule, and only a facts and circumstances test, renting the replacement property for a significant period of time offers substantial evidence of the intent at the time of the purchase and places the taxpayer on sound footing in the event of challenge by the Internal Revenue Service (the "IRS").

Gates v. Commissioner of Internal Revenue Service, 135 T.C. 1 (2010)

Typically, if a taxpayer occupies real estate as his or her principal residence for two of the five years preceding sale, on a joint return the taxpayer can exclude $500,000 worth of gain on the sale from his or her gross income. *See* Code § 121(a). But, when a taxpayer engages in a non-taxable, like-kind exchange under Code § 1031, Code § 121(d)(10) prohibits the taxpayer from excluding gain on sales occurring within five years of the like-kind exchange, even if the taxpayer meets the facial requirements of Code § 121(a). This limitation, therefore, requires taxpayers to adhere to their characterization of real estate and prevents the receipt of dual benefits by manipulation of the tax laws.

Just as Code § 121(d)(10) requires taxpayers who engaged in recent like-kind exchanges to include principal residence gain in their gross income, Code § 121(a) requires inclusion if the two-out-of-five rule is not otherwise satisfied. Whether a property is occupied by the taxpayer as a principal residence for two years seems to be an easy determination, but its application is often complicated and not intuitive. In *Gates v. Commissioner*, 135 T.C. 1 (2010), for instance, a couple owned and used a house as their principal

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residence for two years. The couple wanted to remodel, but due to structural limitations and on the advice of their architect, they demolished the house and rebuilt on the same lot. Once the new construction was completed, the couple sold the property and realized a $591,406 gain. Notably, the couple never occupied the reconstructed house prior to selling it.

Mr. and Mrs. Gates failed to report any of the $591,406 gain from the sale of their reconstructed house on their untimely income tax return. The couple subsequently conceded that $91,406 worth of gain should be taxable, but argued that $500,000 of gain should be excluded pursuant to Code § 121(a). The IRS disagreed, reasoning that the couple demolished their old house, which would have qualified as a principal residence under Code § 121(a), and sold a new house that they had never occupied.

A divided court in *Gates* sided with the IRS and required Mr. and Mrs. Gates to include the full $591,406 in their gross income. Finding the language of Code § 121(a) ambiguous, the court relied on legislative history, Treasury Regulations, and case law to determine that the mere presence of a reconstructed home on the site of the couple's original residence was insufficient to qualify for the income tax exclusion. Rather, the court construed Code § 121(a) narrowly, holding that the exclusion only applied if the home itself was a principal residence, regardless of whether the land on which the new home sat once contained the taxpayer's principal residence.

Like *Goolsby*, the Tax Court's decision in *Gates* brings uncertainty. What happens, for example, if a taxpayer's principal residence burns to the ground, the taxpayer rebuilds a new home, and then sells that home prior to occupying it for a period of two years? Moreover, does Code § 121(a) still apply if a taxpayer substantially and completely remodels his current residence so that only a few features of the original residence remain? If so, is a partial exclusion available, and just how much remodeling can taxpayers engage in before losing their Code § 121(a) exclusion? Though not an issue before, these questions and more are now likely to permeate the landscape.

Just how far the IRS is willing to extend *Gates* remains to be seen. Again, as with *Goolsby*, the tax consequences of every sale or exchange will be different depending on the unique facts of each transaction.

For more information about this topic, please contact the authors or any member of the Williams Mullen Tax Law Team.

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