

## RESIDENTIAL/BUSINESS PROPERTY EXCHANGES

It is possible to sell a property that has been used for both business purposes and residential and use the benefits of Section 1031 (Tax Deferred Sales) and Section 121 (Sale of Personal Residence) simultaneously. A clear differentiation in the books and records of the taxpayer on the portion of the property that has been used for business versus the portion that is used for personal use must be present. A classic example is the taxpayer that has operated an owner occupied bed and breakfast, using the property as part personal residence, part business property. The same principle applies for the taxpayer that deducts a portion of his/her residence for a home office (business use).

Section 1031 can be an effective strategy on the sale of a primary residence that contains excess land surrounding a personal residence (investment property). For example, a taxpayer owns a personal residence situated on 25 acres of land. It has been determined that the usual and customary acreage for similar properties in the vicinity is 3 acres. If the taxpayer has been holding the 22 excess acreage for investment, then that portion of the property can be treated as an exchange. A case in point: if the total value of the property is \$800,000.00 (assuming very low basis) and the residential exclusion can be utilized for up to \$500,000.00 of the gain, then it is possible to protect the \$300,000.00 balance as a tax deferred exchange and avoid any capital gains tax.

Section 121 provides for exclusion from gain up to \$250,000.00 per taxpayer or \$500,000.00 for a married couple filing jointly after two years of ownership. There is no longer a requirement to reinvest the capital gain from the sale of your primary residence into another primary residence; this exclusion can be used every two years.

Taxpayers selling their mixed use property must be aware that they will be subject to capital gains on the sale of the business portion of the property at the rate of 15% and recapture of past depreciation at the rate of 25% if they don't use the provisions of I.R.C Section 1031. Further, many states also impose a capital gains and/or business profits tax that could be due upon the sale of the property.

Tax Court Memo 2006-33, a mixed use case that was part business, part residential provides further insight into how this technique can be utilized. The outcome of this case is that clients who exceed the personal use limitations (14 calendar days or 10% of the days actually rented, whichever is greater) will run the risk of having their deductions disallowed. In summary, the case is this: "Because petitioners use a portion of their bed and breakfast inn as their personal residence, the general disallowance rule of sec. 280A(a), I.R.C., and the exclusive-use limitation of sec. 280A(f) (1) (B), I.R.C. are applicable, and expenses relating to the portion of the inn that is used for both business and personal purposes (i.e., dual-use portion) are not allowable." Clear books and records will avoid the pitfalls while allowing substantial tax benefits.