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REPORTING PRIMARY RESIDENCE SALES

The IRS has modified requirements when § 1031 exchanges and partial rentals are involved.

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WHILE MOST tax deferred exchanges of real property under [§ 1031 of the Internal Revenue Code of 1986](#), as amended (IRC), involve only business or investment property, there is a significant number of transactions that involve properties that have been converted into primary residences. The recently released [Revenue Procedure 2007-12 \(Jan. 22, 2007\)](#) continues the Internal Revenue Service's nearly annual trend, started in 2004, of taking a closer look at these types of exchanges.

[Rev. Proc. 2007-12](#) supersedes [Rev. Proc. 98-20](#), which provided the original guidance for submitting a certification in lieu of the Form 1099-S that is required when selling real estate.

The main purpose of [Rev. Proc. 2007-12](#) is to add provisions relative to sales of primary residences that were acquired through an [IRC § 1031](#) tax deferred exchange. It also expands the certification information required in lieu of Form 1099-S for non-1031 residences involving potential business or rental use of a residence. This revenue procedure applies to all transactions involving primary residences occurring after Jan. 22, 2007.

Form 1099-S Requirements

Most real estate practitioners are familiar with the provisions of [IRC § 6045](#), which require that Form 1099-S, Proceeds From Real Estate Transactions, be filled out with the name, address and taxpayer identification number of the sellers, as well as the gross proceeds of the real estate transaction.

Pursuant to [Treas. Reg. § 1.6045-4](#), a Form 1099-S must be completed even for such non-traditional real estate interests as air rights and cooperative apartments, as well as for property that has been involuntarily converted, as in the case of a condemnation. However, certain transactions are exempt from reporting, such as those involving a gift, bequest, foreclosure, a de minimis transfer involving property valued at less than \$600, or property owned by a corporation.

Pursuant to [IRC § 6045](#), the person responsible for providing the information on the Form 1099-S is the 'real estate reporting person,' which is defined in subsection (e) (2) in the following order as:

- the person responsible for closing the transaction (including attorneys and title insurance companies);
- mortgage lenders;
- the seller's broker;
- the buyer's broker; or
- such other person designated in regulations prescribed by the Secretary.

Depending on the area of the country in which the real estate closing takes place, the Form 1099-S is completed by various parties on the 'real estate reporting person' list.

For example, for transactions completed in the New York metropolitan area, these forms are most likely completed by the seller's attorney or the bank attorney. In areas outside of the New York metropolitan area these forms are more likely completed by realtors and title companies, which are more involved when an attorney is not necessarily present.

Capital Gains Tax Exemption

The purpose of Form 1099-S is to inform the Internal Revenue Service that a real estate transaction has been completed and that the taxpayer will be providing information at the end of its tax year as to whether there was a taxable gain. Since Form 1099-S only alerts the IRS as to the amount of the gross proceeds from the sale, the IRS receives these forms regardless of whether or not there was an actual gain to report on the sale.

There are primarily three ways to avoid paying a gains tax upon the sale of real property:

1. It is a primary residence and the sale complies with the exclusions provided in [IRC § 121](#).
2. The seller has properly structured the transaction under [IRC § 1031](#) as a tax deferred exchange, thereby deferring the recognition of a capital gains tax.
3. The property is 'sold' to a buyer after the threat of condemnation pursuant to Treas. Reg. § 1.1033(a)-1, thereby qualifying the property for [IRC § 1033](#) treatment as if the property had actually been condemned. A [§ 1033](#) condemnation defers the recognition of the capital gain tax similar to a [§ 1031](#) tax deferred exchange.

Previous 1099-S Exception

[Revenue Procedure 98-20 \(Feb. 5, 1998\)](#) provided for an exception to the [IRC § 6045\(e\)](#) reporting requirement for transactions involving the sale of a principal residence, as defined by [IRC § 121](#), where no gain would be reportable and replaced the requirement of filing Form 1099-S with a requirement for the real estate reporting person to obtain a certification from the seller.

The assurances required by [Rev. Proc. 98-20](#) involve four different classifications of transactions in which no gain is reportable due to the exclusion of gain from the sale of a principal residence pursuant to [IRC § 121](#). These four assurances carry over into [Rev. Proc. 2007-12](#) as follows:

1. The seller has owned and used the property as its primary residence for two out of the previous five years;
2. The seller has not obtained an [IRC § 121](#) exemption on another sale within the previous two years;
3. No portion of the residence was used for business or rental purposes after May 6, 1997, by the seller, or the seller's spouse;
4. The seller, or sellers if married, qualify for a full exemption from any capital gain tax pursuant to [IRC § 121](#) so long as the residence is either sold or exchanged for \$250,000 or less, or in the case of a married seller, that the sale or exchange of the entire residence is for \$500,000 or less and the gain for the individual spouse is \$250,000 or less, or if both husband and wife are filing a joint tax return and both qualify for an [IRC § 121](#) exclusion, that the residence was sold or exchanged for less than \$500,000

Rev. Proc. 2007-12 Changes

Although it is a small change, Rev. Proc. 2007-12 modifies the reporting requirements contained in Rev. Proc. 98-20 for residences where a portion of the property was used for business or rental purposes.

Previously, if a married couple was selling a residence, only one spouse was required to provide a certification in lieu of Form 1099-S. The certification form previously contained language wherein the spouse making the assurance also made the assurance on behalf of his or her spouse as well. Rev. Proc. 2007-12 now requires that each seller of the residence provide an individual assurance in lieu of Form 1099-S.

More substantially, Rev. Proc. 2007-12 also expands the certification requirements contained in Rev. Proc. 98-20 by adding new language for primary residence sales whose capital gains tax is excludable from gross income under IRC § 121 but where the premises were originally purchased with an IRC § 1031 tax deferred exchange.

The new assurances contained in Rev. Proc. 2007-12 are added to the existing four requirements as follows:

5. If the seller purchased the residence through an IRC § 1031 exchange, that it must have owned the premises for at least five years prior to the date of the reportable sale, and of those five years, must have used the premises as a primary residence for two of them;

6. In instances where the seller's basis in the residence is determined by reference to the basis in the hands of a person who acquired the residence in an IRC § 1031 tax deferred exchange, the exchange to which § 1031 applied occurred more than five years prior to the date of the current sale or exchange of the residence.

Sections 121 and 1031

The rules involving IRC § 121 eligibility of properties acquired through IRC § 1031 tax deferred exchanges appear to be an oxymoron, since an exchange property must be obtained with the intent to use it for the productive use in a trade or business or for investment purposes, pursuant to IRC § 1031(a)(1).

However, although the initial intent of a purchase must be to hold the property for business or investment purposes, that intent can change over the course of ownership without affecting the viability of the exchange used to acquire the property. For example, a property that was acquired as a rental home for investment purposes with an exchange may later be converted into a primary residence.

Within the past three years the IRS has made changes to the treatment of properties that would technically qualify for both an IRC § 1031 tax deferred exchange and a primary residence capital gains tax exclusion under IRC § 121.

First, on Oct. 22, 2004, IRC § 121 was amended to provide for a five year period of ownership for properties acquired in an IRC § 1031 exchange. In other words, if a business or investment property acquired using an IRC § 1031 tax deferred exchange is later converted to a primary residence the capital gains tax exclusion of IRC § 121 cannot be applied until the taxpayer has lived in the property as its primary residence for at least two years out of a total of five years of ownership.

The second change brought about by Rev. Proc. 2005-14 affects taxpayers who convert a property from a primary residence to a business or investment use, or vice versa. Prior to this revenue procedure taxpayers had to choose between IRC § 121 and IRC § 1031 treatment if both were available to them upon a sale.

For example, if a taxpayer used a property as a primary residence for two years and thereafter rented the property for three years, the taxpayer would have satisfied the requirements of § 121, which provides that a taxpayer must use the property as a primary residence in two out of the preceding five years; as well as satisfying §

1031 by renting out the property for over a year.

It is important to note that in order to qualify for a § 1031 tax deferral the taxpayer must have the intent to hold the property for business or investment purposes and no specific holding period is defined by the IRS. This ruling affected taxpayers positively because it allowed them to combine the benefits of § § 1031 and 121 in certain circumstances.

Rev. Proc. 2005-14 provides that where a taxpayer satisfies the requirements of both § 121 and § 1031, the taxpayer must apply § 121 to the realized gain before applying § 1031. The forgiveness of gain available through § 121 'does not apply to the gain attributable to depreciation deductions for periods after May 6, 1997, claimed with respect to the business or investment portion of a residence.'

This amount, however, may be deferred through the use of a § 1031 tax deferred exchange. In other words, if there is a gain, the amount is first excluded under § 121, and thereafter the remaining amount, including a gain from depreciation, may be exchanged under § 1031.

Taxpayers also obtain an additional benefit when they qualify for the combined treatment under IRC § § 121 and 1031 contemplated by Rev. Proc. 2005-14 for purposes of computing their basis.

Prior to the revenue procedure, a taxpayer would carry over its basis from the relinquished property into the replacement property when structuring the transaction as an IRC § 1031 tax deferred exchange. Due to the forgiveness of the capital gains tax from the § 121 exclusion, the basis of the replacement property is increased by the amount of the capital gain tax that was excluded. Accordingly, the basis of the replacement property is higher due to the application of § 121, which means that the taxpayer will recognize less of a gain if it chooses to sell, instead of exchange, the property in the future.

Certification Form

A sample certification form required by Rev. Proc. 2007-12 is made an appendix to the revenue procedure and is also widely available on the Internet.

However, the exact form and wording of the certification does not have to match the sample certification so long as the certification provides the information required by section 4 of the revenue procedure. The sample form requires the name, address and tax identification number of the seller, a section asking the seller to indicate 'true', 'false' or 'not applicable' for the information required by section 4, and a statement providing that the information is true under penalty of perjury on the date of the sale or exchange of the subject premises.

Modification of Liability

Lastly, Rev. Proc. 2007-12 also relieves the 'real estate reporting person' defined in IRC § 6045(e)(2) from any liability under IRC § § 6721 and 6722.

IRC § 6721 provides penalties for failure to file an information return, and IRC § 6722 provides penalties for a failure to provide a payee statement to the seller. This relief from liability is valid so long as the certification is made in compliance with the revenue procedure and the real estate reporting person does not have any actual knowledge that the assurance contained in the certification is incorrect.

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