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THE PRACTITIONER | MITCHELL A. JACOBS & KNEAVE RIGGALL

Divorced Spouses Can Avoid Tax on Home Sale

FAMILY LAW: Divorcing spouses who lose custody of the family home can defer taxation of the gain realized when the home is sold. The Internal Revenue Code allows it, but the procedure is complicated.

In 1984, Congress enacted Internal Revenue Code Section 1041 to reverse *United States v. Davis*, 370 U.S. 66 (1962), and to make most property transfers between spouses, and former spouses, "tax-free."

A spouse must still recognize gain, however, on: property sales to a third party; transfers to a former spouse which are not "incident to a divorce"; and transfers to a spouse, or former spouse, who is a non-resident alien.

Since many Californians cannot settle the property issues in their divorces without selling their family homes to a third party, nonrecognition statutes other than Section 1041 are very important.

Section 1034 requires that a spouse who lives in the family home until it is sold (an "in-spouse") roll over gain from that sale into the last principal residence purchased within the next two years. While Section 1034 does not define the term "principal residence," Treasury Regulation Section 1.1034-1(c)(3)(i) states that whether a home is a "principal residence ... depends upon all the facts and circumstances in each case, including the good faith of the taxpayer."

In *Robert L. Young v. Commissioner*, 49 T.C.M. (CCH) 1001 (1985), a husband moved out of the family home and rented an apartment. Under the 1975 divorce decree, his ex-wife and child subsequently exclusively occupied the home. Over a year later, the husband "sold" his interest in the home to his ex-wife in return for a termination of spousal support and other payments. He then tried to roll over his share of the gain realized on that transfer into a new principal residence.

On audit, the IRS disallowed that rollover and, after trial, the U.S. Tax Court sustained the IRS, holding that the family home was not Young's principal residence at the time of sale.

Out-spouses are not, however, simply out of luck. Even though they cannot shelter their gain under either Section 1041 or section 1034, another umbrella is available: Section 1031.

Section 1031 also provides for nonrecognition of gain, but only "on the exchange of property held for productive use in trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment."

A like-kind exchange need not be simultaneous; in fact, replacement property need not be identified for up to 45 days, and need not be received for up to 180 days, after transfer of the relinquished property. Any property received by the exchanger that is not of like kind, such as cash or an installment note, is deemed "boot" and gain must be recognized up to the fair market value of the boot received.

In May 1990, the IRS issued proposed Regulation Section 1.1031(a)-3(g), which maps out four safe harbors within which taxpayers may shelter their deferred exchanges from IRS challenge.

While we await the final regulation on this topic, the proposed regulation is quite helpful. One of the safe harbors in the proposed regulation allows the taxpayer's transferee to secure its obligation to transfer the replacement property to the taxpayer by cash held in a "qualified escrow account."

Another safe harbor permits a taxpayer to use a "qualified intermediary" to complete a deferred exchange. An escrow account, or an intermediary, will be "qualified" only if: the escrow holder, or the intermediary, is not the taxpayer or "related party"; and the taxpayer's rights to receive money or other property from the escrow account, or the intermediary, are specifically limited. For purposes of a deferred exchange, a person is a "related party" if:

— He or she acts as the taxpayer's agent (including acting as the taxpayer's employee, attorney, or broker), except that neither routine financial services performed by a financial institution, nor services performed for the taxpayer with respect to Section 1031 exchanges, will be taken into account; or

— His or her relationship with either the taxpayer, or the taxpayer's agent, is described in Section 267(b) or Section 707(b) of the Internal Revenue Code of 1986 (determined by substituting "10 percent" for "50 percent" each place it appears).

As an example, say a married couple, named In Burger and Out Burger, separated in June 1989, with In remaining in the family home with their child, Warren, and Out moving out into an apartment.

After several months of separation, In filed for divorce and, pursuant to California Civil Code section 4700.10, sought a statutory *Duke* order restraining sale of the home. As part of a comprehensive settlement, In stipulated that the Burger house would not be sold until June 1992, the end of Warren's last year of junior high school, and that In and Warren would have exclusive use of the home until then.

The same settlement agreement requires In to pay one-third of any income taxes owed by Out on the sale of the home. Since Out will, at the time of sale, clearly be an "out-spouse," and since the Burgers rolled over gains from a series of their principal residences into the Burger house, Out's income taxes upon that sale will be substantial.

In April 1991, Out's attorney reads this article and recommends that the Burgers consult with a tax adviser. Their tax adviser, in turn, recommends that Out exchange, not sell, Out's interest and then defer taxation of the gain thus realized using Section 1031.

To achieve that goal, Out and In enter into a written lease agreement whereby In rents Out's undivided interest in the Burger house for one-half of the house's fair market rental.

Pursuant to the "shared equity agreement" provisions of Internal Revenue Code Section 280A(d)(3), Out reports that rental income, and deducts such rental expenses as depreciation and mortgage interest, on Out's 1991 and 1992 income tax returns. In February 1992, the Burgers list their house for sale. In May 1992, Ronald McDonnell agrees to buy the Burgers house and to close escrow on June 30, 1992. Out then retains Leona Littlepeople to facilitate a deferred exchange of Out's undivided one-half interest in the Burger house by entering into a deferred exchange agreement.

Under the terms of the deferred exchange agreement, Out will, on June 30, 1992, transfer Out's interest in the Burger house to Leona, subject to McDonnell's right to purchase that interest on that date. On or before Aug. 14, 1991, Out must identify replacement property that is of a like kind to Out's interest in the Burger house.

On or before Dec. 28, 1992, Leona must purchase the replacement property identified by Out and must transfer that property to Out. Out's rights to receive money or other property from Leona are limited to the circumstances described in Proposed Regulation Section 1.1031(a)-3(g)(6).

On June 30, 1992, escrow closes on the Burger house. On Aug. 1, 1992, Out identifies a condominium as replacement property for Out's interest in the Burger house. On Oct. 1, 1992, Leona uses funds from her sale of Out's co-tenancy interest, and from a purchase money mortgage loan arranged by Out, to purchase the condo from Paco Bell.

Pursuant to Revenue Ruling 90-34, 1990-1 C.B. 154, Leona has Paco "direct deed" the condo to Out. Out then rents the condo to Ray Crock for one year. Out's 1992 returns report, as a transaction qualifying for nonrecognition under Section 1031, the like-kind exchange of Out's co-tenancy interest in the Burger house, which was business property for over a year prior to the exchange, for a fee interest in the condo, which is a business property during its rental.

Out also reports rental income, and deducts such rental expenses as depreciation, from the condo on Out's 1992 and 1993 tax returns. In October 1993, the lease on Out's new condo expires and Crock moves out. Out then moves into the condo, thereby converting it from business property to Out's principal residence.

Upon Out's subsequent sale of the condo, gain may be rolled over under section 1034. In summary, out-spouses may defer taxation of the gain from the transfer of a family home to a third party, even though the Sections 1041 and 1034 may provide no protection. The hurdles of section 1031, though high, are not insurmountable and avoiding the grasp of the IRS provides plenty of incentive to run the race.

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