TAX ALERT:
SALE OF PRINCIPAL RESIDENCE ACQUIRED IN A LIKE-KIND EXCHANGE

On October 22, 2004, the President signed H.R. 4520, *American Jobs Creation Act of 2004* . The legislation contains the following addition to Section 121(d) of the Internal Revenue Code.

SEC. 641 of H.R. 4520. RECOGNITION OF GAIN FROM THE SALE OF A PRINCIPAL RESIDENCE ACQUIRED IN A LIKE-KIND EXCHANGE WITHIN 5 YEARS OF SALE.

(a) IN GENERAL - Section 121(d) (relating to special rules for exclusion of gain from sale of principal residence) is **amended by adding** at the end the following new paragraph:

(10) PROPERTY ACQUIRED IN LIKE-KIND EXCHANGE - If a taxpayer acquired property in an exchange to which Section 1031 applied, subsection (a) shall not apply to the sale or exchange of such property if it occurs during the 5-year period beginning with the date of the acquisition of such property.

(b) EFFECTIVE DATE - The amendment made by this section shall apply to sales or exchanges after the date of the enactment of this Act. (Enactment date is October 22, 2004.)

When taxpayers convert a replacement property that was received in an IRC 1031 like-kind exchange to their principal residence, they must have **owned** the property for five years before they can claim the $250,000 or $500,000 exclusion of gain on the sale of their principal residence. They still must have **used** the property as their principal residence for two of the past five years.

Examples:

1. Mr. and Mrs. Smith received 789 Plaza Place, a Section 1031 replacement property on June 1, 1999. They rented the property for three years and then converted it into their principal residence on July 1, 2002. They plan to sell the property on December 1, 2004. May they claim the Section 121 principal residence exclusion on up to $500,000 of their gain?

Answer: Yes. They will have owned the property for five years before selling it. However, any Section 1250 depreciation taken during the three-year rental period must be recaptured at the 25% tax rate.

2. Mr. and Mrs. Jones received 456 Elm Drive, a Section 1031 replacement property, on January 1, 2001. They rented the property for one year and then converted it to their principal residence. After two years of use as a principal residence, they took a job transfer and will rent the property again until June 30, 2005, when they plan to sell it. May they claim the Section 121 principal residence exclusion on up to $500,000 of their gain?

Answer: No. They will not have owned the property for five years after it was acquired in a 1031 exchange on January 1, 2001. However, since the property will be held as a rental when it is sold, they may do another IRC 1031 like-kind exchange. If the property was not sold until after January 1, 2006, they could claim the exclusion.

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