

## Use Both §121 & §1031 Tax Breaks in Exchange of a Single Property

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Revenue Procedure 2005-14, effective January 27, 2005, applies to taxpayers who exchange a single property that satisfies the requirements for both the exclusion of gain from the exchange of a principal residence under §121, and the non-recognition of gain from the exchange of like-kind property under §1031.

To qualify for the principal residence exclusion of up to \$250,000 of gain (up to \$500,000 if married and filing jointly), the taxpayer must have owned and lived in the property for two of the last five years. The taxpayer does not have to live in the property at the time of the exchange.

To qualify for the §1031 like-kind exchange deferral of the gain, the taxpayer, at the time of the exchange, must have held the property for rental or business purposes, and the replacement property must be held for business, rental or investment purposes.

The §121 exclusion must be taken first. Any §1250 depreciation taken on the property after May 6, 1997, must be recaptured and may not be excluded under §121. However, it may be deferred under §1031.

Boot received (both cash and/or debt reduction) of up to \$250,000 is excluded under §121. Additional boot becomes taxable income.

In addition to the exchange of a principal residence converted to a rental or business property, the revenue procedure provides guidance and examples for when on one property there are two structures. One used as a principal residence and one for business purposes. It also addresses the exchange of a single structure used partly as a personal residence and partly for business purposes (such as for a home office).

The following is based on the example in the revenue procedure for a single property converted from a principal residence to rental or business:

Assume the taxpayer is an unmarried individual and the property is currently held as a rental. It was previously used as the taxpayer's principal residence from 2000 to 2004 and qualifies under §121 for exclusion of gain. The house had been bought for \$210,000.

From 2004 until 2006, the taxpayer rents the house to tenants and claims depreciation deductions of \$20,000. In 2006, the taxpayer exchanges the house for \$10,000 of cash and a

townhouse with a fair market value of \$460,000 that the taxpayer intends to rent to tenants. The taxpayer realizes a gain of \$280,000 on the exchange.

The taxpayer's exchange of a principal residence that was rented for less than 3 years for a townhouse intended for rental and cash satisfies the requirements of both §121 and §1031. Section 121 does not require the property to be the taxpayer's principal residence on the sale or exchange date. Because the taxpayer owns and uses the house as a principal residence for at least two years during the five-year period prior to the exchange, the taxpayer may exclude gain under §121. Because the house is investment property at the time of the exchange, the taxpayer may defer gain under § 1031.

In accordance with the revenue procedure, the taxpayer applies §121 to exclude \$250,000 of the \$280,000 gain before applying the non-recognition rules of §1031. The taxpayer may defer the remaining gain of \$30,000, including the \$20,000 gain attributable to depreciation, under §1031. Although the taxpayer receives \$10,000 of cash (boot) in the exchange, the taxpayer is not required to recognize gain because the boot is taken into account for purposes of §1031(b) only to the extent the boot exceeds the amount of excluded gain.

These results are illustrated as follows.

Amount realized	\$470,000
Less: Adjusted basis	- <u>\$190,000</u>
Realized gain	\$280,000
Less: Gain excluded under § 121	- \$250,000
Gain to be deferred	\$30,000

The taxpayer's basis in the replacement property is \$430,000, which is equal to the basis of the relinquished property at the time of the exchange (\$190,000) increased by the gain excluded under §121 (\$250,000), and reduced by the \$10,000 cash boot received.

***The importance of this revenue procedure is that it recognizes that the sale and exchange of a single property may qualify for both the exclusion of gain under §121 and the deferral of gain under §1031.***

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