

Real Estate Journal

THE LARGEST BUSINESS PUBLICATION OF ITS KIND IN THE NATION

Combine personal residence exclusion with tax free exchange to maximize tax savings

1031 Exchange



By Thomas Moylan,
All States 1031
X-Change
Facilitator

Revenue procedure 2005-14 provides welcome relief to many homeowners selling highly appreciated personal residences that double as home offices or rental property. It allows a transfer of a home to qualify for both §121 homesale exclusion and §1031 like-kind exchange treatment. This occurs where the property was used as a principal residence followed by rental of the property (a consecutive use property) or when the house is used both as a principal residence and a home office (a concurrent use property).

The home sale exclusion.

Under §121, a homeowner may exclude up to \$250,000 (\$500,000 for joint filers) of gain from the sale or exchange of a home if he owned and used it as his principal residence for at least 2 of the 5 years before the sale or exchange. The 121 exclusion may apply to a home office or other business portion of a home, but it doesn't apply to the gain resulting from depreciation adjustments (e.g., for partial business use of the residence) attributable to periods after May 6, 1997.

Like-kind exchange.

IRC §1031 provides that no gain or loss will be recognized on the exchange of property held for productive use in a trade or business or for investment if the property is exchanged solely for property of a like kind which is to be held either for productive use in a trade or business or for investment. A personal residence is not considered investment property and cannot be exchanged tax-free under §1031.

A taxpayer contemplating a home office may decide to set up the same now knowing that they can defer any resulting gain under the revenue procedure, provided they enter into a 1031 exchange. The IRS has strict rules for claiming expenses for business use of a personal residence.

Revenue procedure 2005-14.

The IRS offers guidance to taxpayers who exchange single properties that meet the requirements for gain exclusion under §121, and non-recognition of gain on like-kind exchange under §1031. Specific computation directions were provided as follows:

1. IRC §121 must be applied before §1031;
2. IRC §1031 is then applied to gain attributable to depreciation;
3. And boot (cash or debt relief) is to be taken into account only to the extent the boot exceeds gain excluded under §121, with respect

to the relinquished business property.

Application

1. Consecutive use property. To qualify for the §121 exclusion, a taxpayer must have owned and lived at the residence for two out of the preceding five years. Accordingly, a taxpayer with a highly appreciated home could rent the home for a couple of years, and then sell the same qualifying un-

excluded under §121 in excess of cash received under §121.

2. Concurrent use property. A taxpayer contemplating a home office may decide to set up the same now knowing that they can defer any resulting gain under the revenue procedure, provided they enter into a 1031 exchange. The IRS has strict rules for claiming expenses for business use of a personal residence. That part of the home must be used exclusively and regularly as a principal place of business, or exclusively and regularly as a place to meet or deal with patients, clients or customers in the normal course of work. If the taxpayer is an employee, their business use must be for their employer's convenience, not theirs.

Homeowners facing large capital gains may be able to defer much of the tax under the revenue procedure if they properly structure the use and ownership of their property prior to the sale.

Thomas Moylan, Esq. is a principal of All States 1031 X-Change Facilitator, Boston, Mass.