REPRINTED FROM THE
Friday, January 28, 2005
ne NEW ENGLAND
Real Estate Journal
THE LARGEST BUSINESS PUBLICATION OF ITS KIND IN THE NATION

Tax exclusion not immediately available for converted personal residences

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Commencing on October 22, 2004, the $250,000/$500,000 exclusion for gain realized on the sale or exchange of a principal residence will not apply to a sale or exchange of a residence acquired in a tax-free like-kind exchange during the five-year period before the sale.

Exclusion on Sale of Personal Residence

A taxpayer generally may exclude up to $250,000 ($500,000 for certain married couples filing joint returns) of gain realized on the sale or exchange of a principal residence. To be eligible for the exclusion, the taxpayer must have owned the residence and used it as a principal residence for at least two years of the five-year period ending on the date of the sale or exchange. Prior to the enactment of the American Jobs Creation Act of 2004 (hereinafter the "2004 Jobs Act"), there were no special rules relating to the sale or exchange of a principal residence that was acquired in a like-kind exchange within the five year period prior to the sale.

Tax Free Exchanges

Internal Revenue Code ("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. The taxpayer's basis in the replacement property will generally equal his basis in the relinquished property, unless "boot" is received or given. The taxable gain is not eliminated, it is merely deferred until a subsequent sale. Because the replacement property generally has a low carry-over tax basis, the taxpayer typically faces a large taxable gain upon the sale or exchange of the replacement property

Planning Technique – Conversion to Qualify for Exclusion

For a variety of reasons, many investment property owners opt to pay the tax triggered by the sale of their property. With advance planning, however, some of these taxpayers have been able to exclude a portion of the tax resulting from the sale, by converting the investment property to their personal residence, and excluding gain on the sale under IRC § 121. This conversion is accomplished by ceasing rental activities, physically moving back into the property, and treating the same as their personal residence for tax purposes (i.e. elimination of Schedule E on their personal income tax returns, deducting property taxes on Schedule A etc.). To be eligible for the exclusion, the taxpayer must have owned the residence and used it as a principal residence for at least two years of the five-year period ending on the date of the sale or exchange.

New Law

As is evident from enacted legislation and records of legislative history, Congress believes that the exclusion of gain allowable upon the sale or exchange of principal residences serves an important role in encouraging home ownership. Congress does not believe that the exclusion is appropriate for properties that were recently acquired in like-kind exchanges.

The 2004 Jobs Act provides that if a taxpayer acquired property in a like-kind exchange to which IRC § 1031 applied, the $250,000/$500,000 exclusion that applies to gain realized on the sale or exchange of a principal residence under IRC § 121(a) does not apply to the sale or exchange of that property if the sale or exchange occurs during the five-year period beginning with the date of the acquisition of the property. (IRC § 121(d)(10) as amended by 2004 Jobs Act) In other words, the exclusion for gain on the sale or exchange of a principal residence does not apply if the principal residence was acquired in a like-kind exchange in which any gain was not recognized within the previous five years.

As long as the sale or exchange of the taxpayer's principal residence acquired in a tax-free like-kind exchange occurs more than five years after the date of the acquisition of the residence, IRC § 121(d)(10) doesn't bar the application of the IRC § 121 exclusion to any gain realized on the sale or exchange. But, the sale or exchange of a principal residence still has to satisfy the other requirements for the IRC 121(a) exclusion

For purposes of the IRC § 121(a) exclusion, IRC § 121(c) provides for a reduced exclusion that applies when the taxpayer does not meet the two-year ownership and use requirements by reason of a change in place of employment, health, or unforeseen circumstances. IRC 121(d)(10) doesn't provide any exceptions to the five-year holding period in situations similar to those described in IRC 121(c) .

Conclusion

Converting investment property to a personal residence is a popular technique utilized by many taxpayers to position a subsequent sale of the property for the IRC § 121 exclusion. This technique is still viable for the patient taxpayer, who is willing to wait the full five years required by the 2004 Jobs Act before qualifying for the exclusion.

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