



THE GREAT REAL ESTATE TAX BREAK

COMBINING A LIKE-KIND EXCHANGE AND THE PRINCIPAL RESIDENCE EXCLUSION

In the Taxpayer Relief Act of 1997, Congress passed a major tax break for everyone who owns their home. When the like-kind exchange rules and the homeowner exclusion rules are both used, taxpayers can achieve a significant tax break. In October 2004, Congress revised Section 121 to require a principal residence obtained in a like-kind exchange to be owned for five years before qualifying for the homeowner exclusion.

Q. What is the principal residence exclusion rule?

A. Married couples filing jointly can exclude up to \$500,000 of gain when they sell their principal residence. Single taxpayers can exclude up to \$250,000 of their gain. To qualify for the exclusion, you must have owned and used the home as a principal residence for an aggregate of two years out of the five years before the sale.

Q. Can I exchange our current rental, investment, or business property for a home in a location where we may wish to retire, rent it out, then sell our current principal residence and convert the replacement property to our new principal residence?

A. Yes. This approach will maximize your tax savings. When you transfer your current investment, rental, or business property as part of a like-kind exchange, you defer the tax on the gain. This is reflected in the lower basis assigned to your replacement property. When you sell your current principal residence, you exclude the gain. Then, after you convert your replacement property to your new principal residence, you become eligible once again for exclusion of up to \$500,000 of gain after you have **owned** the replacement property for five years and **used** it as a principal residence for two years.

Q. When can I convert my investment, rental, or business property to personal use?

A. You can convert a rental, investment, or business property to personal use at anytime you desire without paying any tax at that time. If you just acquired the property by doing a like-kind exchange, you must hold the property as an investment, rental, or business property. No one can tell you how long the exchange replacement property must be held in that status before you convert it to personal use, but most tax experts recommend not less than one year.

Q. If we do convert our rental to our principal residence, how long do we need to own the property before selling it and claiming the exclusion once again?

A. After converting your rental to your new principal residence, you must have owned the property for five years and used it for two years as your principal residence before you can claim the exclusion again. Tax will be due only on any depreciation taken after May 6, 1997. (Prior to passage in October 2004 of H.R. 4520, there was no five-year ownership restriction.)

Q. Must you buy another property to get the exclusion?

A. No. The previous law (IRC 1034) which required you to purchase another property to “rollover” your gain was abolished in 1997.

Q. Can you combine the principal residence exclusion and a like-kind exchange on the same property?

A. Yes. If you own a property of which part is your principal residence and part is an investment, rental, or business property, you may use both the principal residence exclusion and a 1031 like-kind exchange. An easy-to-understand example is the sale of a duplex where you rented out one half and lived in the other half. The gain on the portion in which you lived can be excluded, and the tax for the gain on the part you rented out may be deferred using a like-kind exchange.

- Q. Can the ownership and use tests for the exclusion be met at different times?**
- A. Yes. You can meet the ownership and use tests during different two-year periods. However, you must meet both tests during the five-year period ending on the date of the sale.
- Q. When you sell the property, must you be living there to claim the exclusion?**
- A. No. You must only have lived in the property for two of the last five years.
- Q. Are there any exceptions to the principal residence two-year rule?**
- A. Yes, you may get a reduced exclusion if you must sell due to a job location change that qualifies for the moving expense tax deduction, for health reasons, or under special circumstances.
- Q. If you qualify for the exception, how do you figure the reduced exclusion?**
- A. Take the smaller of the number of days you lived in the property or the number of days you owned the property during the last five years prior to the date of sale. Divide that number by 730 days. Then multiply \$250,000 or \$500,000 by the decimal you obtained. That amount is your maximum exclusion (see Worksheet 3 in IRS Publication 523).
- Q. How old must you be to claim the exclusion?**
- A. There is no age restriction. The previous requirement to be 55 or older to get a “once-in-a-lifetime” exclusion of \$125,000 was also abolished in 1997.
- Q. Do both married taxpayers have to own the property to exclude up to \$500,000 of gain?**
- A. No. Only one spouse has to own the property. But both must have lived in the property for two years and file a joint return for the year of the sale to claim the \$500,000 exclusion.
- Q. How often can you sell your principal residence and exclude the gain?**
- A. Once every two years. You cannot exclude the gain on the sale of your principal residence if, during the two-year period ending at the date of sale, you sold another principal residence at a gain and excluded all or part of the gain. To exclude up to \$500,000 of the gain, neither spouse can have excluded the gain from the sale of a principal residence during the past two years.
- Q. If I rented out my principal residence for awhile, do I have to claim any gain?**
- A. The gain to be excluded must be reduced by the amount of depreciation taken after May 6, 1997. This recapture of depreciation is then reported on IRS Form Schedule D (see example in IRS Publication 523).
- Q. May the time we were away from our principal residence on vacation still be counted toward the two years we must live in the house to qualify for the exclusion?**
- A. Yes. Short, temporary absences for vacations or other seasonal absences, even if you rent out the property during the absences, are counted as periods of use.
- Q. If I use part of my property for business purposes, such as my garage, may I still exclude the gain on that part of the property?**
- A. If during the past five years that part was used as part of your principal residence for at least two years, then you may exclude the gain on that part of the property, except for the depreciation taken.
- Q. Where can I get more information?**
- A. Get a free copy of IRS Publication 523, *Selling Your Home*, by calling 800-829-3676, call us at 800-795-0769 for a free copy of our information package on *How to Do a Tax-Deferred Exchange*, and contact your tax advisor.

This publication is designed to provide accurate information on tax-deferred exchanges. The publisher is not engaged in rendering legal or accounting services. If legal or tax advice is required, the services of a competent professional should be sought.

Realty Exchange Corporation

7400 Heritage Village Plaza, Suite 102, Gainesville, VA 20155

703-754-9411 ~ 800-795-0769 ~ Fax 703-754-0754

www.1031.us