



1031 EXCHANGES AND PRIMARY RESIDENCES

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Primary residences are normally not a consideration when talking about IRC §1031 tax deferred exchanges, but some recent rulings have clarified what the results are when these two areas intersect. Revenue Procedure 2005-14 (1/27/2005, corrected February 3, 2005) provides for clarification and additional benefits for those taxpayers converting property between a primary residence use and a business and investment. In addition, it also provides guidance for properties used partially as a primary residence and partially as a business or investment property.

Unlike an IRC §1031 tax deferred exchange, which defers a gain upon the sale of business or investment property, IRC §121 provides for an exclusion of the capital gain tax upon the sale of a principal residence. The maximum exclusion under §121 is \$250,000 for those filing as single and \$500,000 for those filing a joint return. Effective October 22, 2004 the primary residence exclusion contained in IRC §121 was amended to provide for a five year waiting period for property which was acquired using an IRC §1031 exchange. In other words, if a business or investment property acquired using an IRC §1031 tax deferred exchange is later converted to a primary residence the capital gains tax exclusion of IRC §121 can not be applied until the taxpayer has lived in the property as its primary residence for at least two years out of a total of five years of ownership. It is important to note that a taxpayer's initial intent must be to acquire the

replacement property as business or investment property and not as their primary residence.

Prior to Rev. Proc. 2005-14 when taxpayers converted a property from a primary residence to a business or investment use, or vice versa, taxpayers had to choose between IRC §121 and IRC §1031 treatment if both were available to them upon a sale. For example, if a taxpayer used a property as a primary residence for three years and thereafter rented the property for two years the taxpayer will have satisfied the requirements of §121, which provides that a taxpayer must use the property as a primary residence in two out of the preceding five years; as well as satisfying §1031 by renting out the property for over a year. It is important to keep in mind that in order to qualify for a §1031 tax deferral the taxpayer must have the intent to hold the property for business or investment purposes and no specific holding period is defined as sufficient by the Internal Revenue Service. With this ruling taxpayers may now combine the benefits of these two code sections.

Where a taxpayer satisfies the requirements of both IRC §121 and IRC §1031 the taxpayer must apply §121 to the realized gain before applying §1031. The forgiveness of gain available through §121 "does not apply to the gain attributable to depreciation deductions for periods after May 6, 1997, claimed with respect to the business or investment portion of a residence." This amount,

however, may be deferred through the use of §1031. In addition, for purposes of §1031 the amount of cash or non-like kind property (also known as boot) which would traditionally yield a taxable event, taxpayers are able to exclude the amount under §121 with respect to the relinquished business property.

Lastly, taxpayers who utilize the benefits of Rev. Proc. 2005-14 to get the combined treatments of §121 and §1031 also obtain a benefit when computing their basis. Normally a taxpayer would carry over its basis from the relinquished property into the replacement property when structuring the transaction as an IRC §1031 tax deferred exchange. By combining the benefits of §121 and §1031 the basis of the replacement property is increased by the amount of gain recognized by §121. Accordingly, the basis of the replacement property is higher due to the application of §121 which means that the taxpayer will recognize less of a gain if it chooses to sell, instead of exchange, the property in the future.

