Housing Counsel: The IRS May Have Just Given You Some Very Good News

If you owned a home which at one point was your principal residence, but was later rented out, depending on the facts -- and the timing -- of your situation, the IRS has just given you some very good news. You may be able to combine the principal residence exclusion of up to $500,000 with a 1031 (Starker) exchange, and in fact pay no tax at all when you sell your house.

Let's first review some basic principles of real estate tax law.

Under Section 121 of the Internal Revenue Code, if you have lived in your principal residence for two out of a five year period before it is sold, you can exclude up to $500,000 of your profit (if you are married and file a joint return) or up to $250,000 of your gain (if you file a separate tax return). Your house has to be your principal residence.

Under Section 1031 of this same tax code, if you exchange one piece of investment property (called the "relinquished property") for another (called the "replacement property"), you may be able to defer all of the profit you have made when the relinquished property is sold. There are specific time limits on a 1031 exchange: you must identify one or more replacement properties within 45 days from the day you sold the relinquished property, and you must actually go to closing on that replacement property (or properties) within 180 days of that earlier settlement.

But if you lived in your house for three years, and rented it out for two years, how do you treat the profit you make when it's sold? This becomes especially important if you have made more than $500,000 in profit from the time you first purchased your house. Up until recently, it was assumed that if you made more than the exclusion, you had to pay capital gains tax on this additional amount of gain.

The IRS, on February 14, 2005, gave us all a Valentine's day present. It issued Revenue Procedure 2005-14, which specifically allows taxpayers to combine the home-sale exclusion (under section 121) with the Starker exchange rules (under section 1031).

Here is an example provided by the IRS:

Edward Exchanger buys a house for $210,000 in 2000, and uses it as his principal residence until 2004. From 2004 to 2006, he rents the house to tenants. Because the property is now rental property, he takes depreciation deductions of $10,000 for each rental year -- namely $20,000.

In 2006, he exchanges this property for $10,000 in cash and a townhouse with a fair market value of $460,000. Edward intends to -- and does -- rent out this new property.

According to the IRS example, Edward has realized gain in the amount of $280,000. ($460,000 + $10,000 cash = $470,000, less $210,000 purchase price, plus $20,000 in depreciation).

Edward qualifies for the $250,000 home-sale exclusion. He is single, and has owned and lived, in the house for two out of the previous five years before it was sold. He also qualifies for 1031 treatment, because the house was rented out, and thus was investment property at the time of its sale. Additionally, the replacement property he received is also investment property.

The IRS makes is clear that section 121 (home-sale exclusion) does not require that the property be the taxpayer's principal residence on the date of the sale or exchange. In fact, the clear language of this section makes it clear that you can rent it out, so long as you have lived there two out of the previous five years.

According to the IRS:

Because (Edward) owns and used the house as his principal residence for at least 2 years during the 5-year period prior to the exchange, (Edward) may exclude gain under section 121. Because the house is investment property at the time of the exchange, (Edward) may defer gain under section 1031.

The IRS requires that you first use up your home-sale exclusion. Here, Edward has made a gain of $280,000, so he reports a $250,000 exclusion on his next year's tax return. But the IRS will now allow Edward to also utilize the Starker exchange procedures. Accordingly, Edward may defer the remaining gain of $30,000 -- including the $20,000 gain attributable to depreciation -- under Section 1031. The IRS presented the following illustration:

Amount Realized		$470,000
Less:	Adjusted Basis	190,000
	Realized Gain	280,000
Less:	Gain excluded under §121	250,000
	Gain to be deferred under §1031	$30,000

How does this all end up? Edward pays no tax, even though he has made a lot of profit on the sale of his house. Edward gets to keep, tax free, the $10,000 cash he received in the exchange transaction, and his basis for tax purposes of the replacement property is $430,000. This is computed by taking the basis of the relinquished property at the time of the exchange ($190,000), plus the gain

excluded under section 121 ($250,000) and reduced by the cash he received ($10,000).

This sounds complicated -- and it is. You should consult both your tax advisor, as well as your accountant before you make any serious commitments -- and definitely before you sign any legally binding contracts.

The IRS did not, however, address yet another loophole in the tax laws. Edward can rent out the replacement property for at least one year, and then decide to move back into it. Up until this past October, if he had lived in the house for a period of two more years, he would once again be eligible for the home-sale exclusion of another $250,000. However, in October of 2004, Congress passed the American Jobs Creation Act. That act now requires that since Edward acquired the replacement property by way of a Starker exchange, he cannot take this exclusion for a period of five years beginning on the date he obtained title to that property.

However, at the end of five years, the property presumably will have increased in value. Edward -- should he desire to sell it -- would then be eligible for this home-sale exclusion. Furthermore, there is no time limit on when Edward can do yet another 1031 exchange; if he wants, he can exchange this property once again for another investment property at any time.

There are many people who have made a lot of money on the real estate appreciation that has taken place over the past few years. If your gain will exceed the statutory limits under section 121, here is one way of avoiding -- or at least deferring -- paying capital gains tax.

It takes a lot of patience and counseling from professionals, but the IRS has now spoken, and we should all be able to take advantage of this holiday gift.

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