

New Law Limits §1031 Exchanges Involving a Principle Residence

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On October 22, 2004, President Bush signed into law corporate and foreign tax legislation that also contained a provision affecting IRC §1031. Under this provision, a taxpayer who exchanges under IRC §1031 into a rental house as a replacement property that is later converted into their primary residence, is not allowed to exclude gain under the principle residence exclusion rules of IRC §121 unless the sale occurs at least five years from the date of its acquisition. The Conference Agreement on H.R. 4520 includes the following provision to amend §121(d).

Section 840. Recognition of gain from the sale of a principle residence acquired in a like-kind exchange within five years of sale.

(10) Property acquired in like-kind exchange.

If a taxpayer acquired in an exchange to which section §1031 applied, subsection (a) shall not apply to the sale or exchange of such property if it occurs during the five-year period beginning with the date of the acquisition of such property.

The result of this additional requirement to IRC §121 is that anyone exchanging into a rental property which they subsequently convert to personal use will have to wait at least five years from the acquisition before they can sell it as their residence and exclude any gain under IRC §121(a).

The change to the home seller rules of IRC §121 became effective for principle residence sales occurring on or after October 22, 2004. Any taxpayer who previously acquired their current residence through a tax deferred exchange within the past three years will now have to wait at least another two years before selling their home and excluding the gain. This assumes they meet the two out of the five year occupancy test.

