

NEW TAX BILL AFFECTS EXCHANGES

"CHANGES ARE EFFECTIVE FOR SALES CLOSING AFTER OCTOBER 22, 2004"



FIVE YEAR COMBINED HOLD PERIOD REQUIRED TO EXCLUDE GAIN UNDER IRC §121

Compliments of

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, an Exchanger who performs an IRC §1031 tax deferred exchange into a rental house as replacement property and later the rental house is converted into the Exchanger's principal residence, is not allowed to exclude gain under the principal residence exclusion rules of IRC §121 unless the sale occurs at least five years after the closing date of the replacement property purchase. The Conference Agreement on H.R. 4520 includes the following provision to amend §121(d):

Sec. 840. Recognition of gain from the sale of a principal residence acquired in a like-kind exchange within 5 years of sale. (10) PROPERTY ACQUIRED IN LIKE-KIND EXCHANGE -- If a taxpayer acquired property 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 5-year period beginning with the date of the acquisition of such property.

The change to IRC §121 is effective for principal residence sales occurring on or after October 22, 2004 and all investors who previously acquired their current residence through a §1031 exchange within the past three years will now have to wait at least two more years before selling their residence to exclude the gain. This assumes they meet the two out of five year principal residence test.

The result of this additional requirement to IRC §121 is that an investor exchanging into a rental house, which is later converted to a principal residence, will have to wait a minimum of five years to exclude capital gain under IRC §121 (subject to the maximum exclusion restrictions of \$500,000, married filed jointly; \$250,000 filing as a single). Also note that the Exchanger must acquire the replacement property with the intent to hold it for investment. There is no defined "holding period" as to how long a property must be held to be considered held for investment.

AN EXAMPLE

An Exchanger completes an exchange for a rental home that is held for investment and rents the property out for two years. The exchanger decides to move into their former rental house and live in it as their principal residence. Under the new law, the Exchanger will have to wait for at least three more years before selling the principal residence and excluding gain under IRC §121.



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