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Revenue Procedure 2005-14: Excluding and Deferring Capital Gain Simultaneously

Under Section 121 of the Internal Revenue Code ("IRC"), when a taxpayer sells a principal residence, they are entitled to exclude $250,000 of gain ($500,000 for married taxpayers) from taxation. Under Section 1031 of the IRC, a taxpayer may exchange investment property for other investment property and defer capital gains on the sale. Under Revenue Procedure 2005-14, when a property is used for both purposes – i.e. as a principal residence and for investment – a taxpayer may take advantage of both the 121 capital gain exclusion and the 1031 capital gain deferral.

What types of property qualify?

Property that is currently rented out but was, within the five years preceding the date of the exchange, used by the taxpayer as a principal residence for at least two years; property that has two structures– the taxpayer's residence and another used for business; and, property with one structure used partially as a residence and partially for business. For guidance, Revenue Procedure 2005-14 provides six detailed examples.

Property currently rented, but used as a personal residence in prior years. If the taxpayer owned and lived in the residence for two of the preceding five years, they are eligible for the $250,000 Section 121 exclusion even though on the date of transfer, the taxpayer no longer lived in the residence. Note however, if the principal residence was originally acquired as investment property and later converted to a residence, in order to qualify for the 121 exclusion, the taxpayer must have owned the property for a total of five years and of those five years, must have used it as a principal residence for two years. In other words, property used for investment but later converted to a principal residence and then converted back to investment must meet the two-year and five-year requirements.

Property with two separate structures, one used as a principal residence and one used for business. Section 121 is applied just to the residence and Section 1031 is applied to just the investment portion.

One structure with a combined use as a principal residence and for business/ investment. The entire property is treated as the taxpayer's principal residence for purposes of satisfying the two-year use requirement. The taxpayer must allocate the basis and amount realized using the same method the taxpayer used to determine depreciation adjustments.

Some rules to consider. First, Section 121 must be applied to gain before applying Section 1031. Second, the exclusion under Section 121 does not apply to gain attributable to depreciation deductions claimed for periods after May 6, 1997 with respect to the business or investment portion of a residence, but Section 1031 may apply to such gain. Cash or other non-like kind property ("boot") received in an exchange is taken into account only to the extent the boot exceeds the gain excluded under Section 121. Finally, the Taxpayer Relief Act of 1997 repealed the once-in-a-lifetime exclusion provision in Section 121 and replaced it with the elective exclusion of $250,000 (or $500,000 if applicable) and made this exclusion available every two years.

Although Revenue Procedure 2005-14 is highly beneficial, the application of the rules can be complicated. Thus, a prudent taxpayer should carefully consider these rules and the examples in the Revenue Procedure with the assistance of their tax advisor. Likewise, the taxpayer should inform their intermediary and their closing agent before starting an exchange that they intend to exclude cash under Section 121 so that the excluded cash is not included in the exchange proceeds.

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