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PRINCIPAL RESIDENCES AND TAX-FREE EXCHANGES

BY JERROLD J. STERN

Married taxpayers filing jointly can avoid tax on up to \$500,000 of gain when they sell their principal residence. For single taxpayers, the gain exclusion is \$250,000. However, all gain is taxable if the residence was acquired during the previous five years as part of a tax-free like-kind exchange. The 2005 Tax Act clarifies the gain exclusion rule for such residences.

Tax-Free Like-Kind Exchange Rules

Tax law allows exchanges of certain like-kind property to be tax free. The definition of "like-kind" is very broad for real estate. Any type of business or investment real estate can be exchanged for any other type of business or investment real estate.

All of the following types of properties are considered to be like-kind and, thus, any combination can be exchanged tax free: investment land, office building, warehouse, factory, farm building, parking lot, and residential rental property. The like-kind exchange rules do not apply to a taxpayer's personal residence(s) or real estate held in the inventory of a real estate dealer.

Whether a person is a dealer for tax purposes is a "facts and circumstances" determination — that is, it is determined on a case-by-case basis. Brokers, agents and individuals with no real estate credentials may be considered dealers under some conditions.

To illustrate a tax-free exchange, say John purchases land for \$200,000 and holds it as investment property. Assume

John is not a real estate dealer. Two years later, the land is worth \$240,000 and John trades it for a single-family home worth \$240,000 from Barbara. John will rent the home to unrelated parties. For John, the transaction qualifies as a tax-free like-kind exchange. He pays no tax on the \$40,000 gain (\$240,000 less \$200,000). John's tax basis for the home is \$200,000.

If he later sells the home for more than \$200,000, his gain from the sale would be taxable. If John's original plan was to use the home for personal purposes (either as his principal residence, a second home or a vacation home), the \$40,000 gain would be taxable in the year of the exchange.

What happens if Barbara, the seller in this example, is a real estate dealer specializing in single-family residences? If her tax basis in the home is \$205,000, her gain is \$35,000 (\$240,000 less \$205,000) and is taxable as ordinary income because of her dealer status. Note that John benefits from the like-kind exchange rules even if they do not apply to Barbara.

Subsequent Sale of Principal Residence

As mentioned previously, the principal residence gain exclusion does not apply if the property is acquired in a tax-free like-kind exchange during the previous five years. Continuing the example, assume the like-kind exchange occurs on Jan. 1, Year 1 and John immediately begins renting the home to an unrelated party. On Jan. 1, Year 2, the tenant moves out and the

home becomes John's principal residence. John sells the home for \$290,000 on Jan. 2, Year 5.

The gain exclusion rule does not apply because the home was acquired in a tax-free exchange four years previously. Thus, the \$90,000 gain (\$290,000 less \$200,000) is taxable. However, if John sells the home on or after Jan. 2, Year 6, the transaction qualifies for gain exclusion treatment.

The same rules apply if the residence is gifted to a family member or anyone else. If John gives the home to his daughter on Jan. 1, Year 3 and she sells the home on Jan. 2, Year 5, all gain is taxable as in the above example. However, if she sells the home on or after Jan. 2, Year 6, she would benefit from gain exclusion treatment.

In contrast, gain exclusion treatment remains intact if a taxpayer receives property as a bequest. Thus, if John dies and the daughter inherits the property, she need only meet the general rules for gain exclusion when she sells the property. That is, she would benefit from gain exclusion if she uses the house as her principal residence for two out of the five years prior to sale. The daughter's tax basis for the property is generally its fair market value on the date of death.

Tradeoff

If a taxpayer determines that the benefits from future use of the gain exclusion outweigh the benefits of tax-free exchange treatment, he or she should intentionally fail the tax-free treatment requirements. For example, if the tax-free exchange gain is small and the

anticipated gain from a future sale of the property is large, it may be best to treat the property as a principal residence immediately.

In this way, the transaction fails the like-kind exchange rules (since they do not apply to principal residences), a small amount of tax is paid now on the small gain but a large tax amount on a

future gain is avoided when the property is ultimately sold. Obviously, a number of assumptions would have to be made to perform this analysis, the most difficult of which would be the anticipated year of sale and the anticipated sale price.

The tax rules and tax planning for like-kind exchanges followed by the sale of

property as a principal residence can be complex. Consultation with a tax accountant or tax attorney is recommended. ♣

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