



e-Report

YOUR SOURCE FOR UP-TO-DATE 1031 EXCHANGE NEWS

Application of Principal Residence Exclusion to Property Currently or Formerly Used for Investment

Internal Revenue Code ("IRC") §121 allows taxpayers selling a principal residence to exclude \$250,000 of gain from taxation (or, \$500,000 for married taxpayers, filing jointly) as long as they have lived in the residence for 2 out of the preceding 5 years.

However, taxpayers who sell a principal residence formerly used as an investment property are entitled to only a portion of the §121 exclusion.

Summary of Rules

1. Taxpayers who sell a principal residence used only as a principal residence. §121 provides for a \$250,000/\$500,000 exclusion as long as they have used the property as their principal residence for 2 of the preceding 5 years.

2. Taxpayers who sell a principal residence, originally acquired as an investment property. Pursuant to the Housing Assistance Tax Act of 2008, these taxpayers are entitled to only a portion of the §121 exclusion. They must use the formula described below:

a. The period of non-qualified use (period not used as a principal residence) must be divided by the total years of ownership to determine the amount of gain that is not eligible for exclusion under §121.

e.g. $\frac{\text{aggregate period of "non-qualified" use}}{\text{total period of ownership}} = \text{percentage of gain not eligible from exclusion from taxation}$

Non-qualified use prior to 1/1/2009 is disregarded for purposes of the above calculation. Also, the §121 exclusion does not apply to gain attributable to depreciation.

b. Additionally, they must have owned the property for five years to be entitled to any §121 exclusion. (See IRC §121(d), as amended by § 840 of the American Jobs Creation Act of 2004).

3. Taxpayers who sell investment property, formerly used as a residence. Pursuant to Rev. Proc. 2005-14, they can exclude \$250,000/\$500,000 as long as they have used the property for their principal residence for 2 of the preceding 5 years. However, the § 121 exclusion does not apply to gain attributable to depreciation deductions for periods after May 6, 1997

Taxpayers selling a principal residence which was formerly used as an investment/rental property or those that are selling an investment/rental property formerly used as a principal residence should consult with their tax or legal advisors regarding the application of §121 and/or §1031 to their particular situation.