



\$500K tax break allowed on house acquired in exchange

Property must be owned for 5 years to qualify

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DEAR BOB: My wife and I are both 85. We bought our house five years ago in an Internal Revenue Code 1031 tax-deferred exchange. It was our third 1031 exchange in a series so our cost basis is very low. We rented out the house for about three years and took it over as our home two years ago. Our plan was to sell it eventually and claim the \$500,000 exemption to offset the capital gains tax we will owe on the 1031 deferred gains. However, I read in IRS Publication 17, "You cannot claim the exclusion if you acquired your home in a like-kind exchange." Is there any legal way to get around this? --Don DeL.

DEAR DON: Yes. As you probably know, Internal Revenue Code 121 allows principal-residence sellers to qualify for up to \$250,000 tax-free capital gains (up to \$500,000 for a qualified married couple). To qualify, you must own and occupy the primary home at least 24 of the last 60 months before its sale. You and your wife appear to qualify. Only one spouse's name need be on the title.

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Effective Oct. 22, 2004, IRC 121 was amended to require a principal residence acquired in an IRC 1031 tax-deferred exchange to be held for at least five years to qualify for IRC 121. But only 24 months of owner-occupancy is required.

This tax law change was enacted to prevent investors from trading their investment property into a residential property, converting it to the owner's principal residence, and quickly qualifying for up to \$500,000 tax-free sales profits after only 24 months.

Now such a transaction requires at least five years of ownership including at least 24 months of owner-occupancy. However, depreciation you deducted will be taxed at the special 25 percent federal recapture tax rate. For full details, please consult your tax adviser.