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The Sale of a Principal Residence Acquired Through a Like-Kind Exchange

Gregg Esenwein
Specialist in Public Finance
Government and Finance Division

Summary

When business or investment property is exchanged for property of a “like kind,” (often referred to as a 1031 exchange) no gain or loss is recognized on the exchange, and therefore, no tax is paid at the time of the exchange on any appreciation in the value of the property. The like-kind exclusion is sometimes combined with the exclusion of tax on the gain from the sale of a principal residence. In effect, this combination can allow taxpayers to avoid paying tax on the gain from the sale of their investment property.

The American Jobs Creation Act of 2004, enacted on October 22, 2004, addressed this issue of combining like-kind exchanges with the exclusion of tax on the sale of a principal residence. As of the date of enactment, the exclusion for gain on the sale of a principal residence no longer applies if the principal residence was acquired in a like-kind exchange within the past five years. In effect, this requires the taxpayer to hold the exchanged property for a full five years before it would qualify as a principal residence. This change reduces, but does not eliminate, the attractiveness of combining like-kind exchanges with the principal residence exclusion. This report will not be updated.

Background

When business or investment property is exchanged for property of a “like kind,” no gain or loss is recognized on the exchange and therefore no tax is paid at the time of the exchange on any appreciation in the value of the property. (The section of the Internal Revenue Code covering these transactions is section 1031, and hence, these transactions are often referred to as 1031 exchanges.) Stocks and financial instruments are not eligible for this provision, so it is not useful for rearranging financial portfolios.

Tax is deferred on these like-kind exchanges until the exchanged property is ultimately sold and the seller receives actual monetary compensation. This is in contrast to the general rule that any sale or exchange for money or property is a taxable event. Since money has a time value (a dollar today is more valuable than a dollar in the future) tax deferral effectively lowers the tax rate on the income generated by the exchange.

Individuals, corporations, partnerships, and trusts all qualify for 1031 exchanges. Furthermore, the like-kind exchange rules have been liberally interpreted by the courts to allow tax-free exchanges of property of the same general type but of very different quality and use. All real estate, in particular, is considered “like-kind,” allowing a retiring farmer from the Midwest to swap farm land for a Florida apartment building tax-free.

Under current law, a taxpayer engaged in a section 1031 exchange has up to 45 days from the date of the closing on the transfer of the original property to identify the replacement property. The taxpayer must then receive the replacement property within 180 days to qualify as a section 1031 exchange and receive the benefits of the tax deferral.

The 1031 provision is very popular with real estate interests, some of whom specialize in arranging property exchanges. It is useful primarily to persons who wish to alter their real estate holdings without paying tax on their appreciated gain.

One popular real estate investment strategy involves combining 1031 exchanges with the exclusion from the federal income tax on the gains from the sale of a principal residence. Under current law, taxpayers filing joint returns may exclude up to \$500,000 of capital gain (\$250,000 for single filers) from the sale of their principal residence. To qualify for the principal residence exclusion, taxpayers must meet certain ownership and use tests. During the five-year period ending on the date of sale, the taxpayer must have owned the home for at least two years and lived in the home as the taxpayer’s main residence for two years.

The exclusion on the gain from the sale of a principal residence is often combined with a 1031 exchange in order to avoid paying tax on the exchange (sale) of the taxpayer’s investment property. Prior to 2004, this had been a very attractive arrangement for taxpayers who wanted to relocate or retire to a different area. For example, consider the case of a taxpayer who owned his own home and also owned an investment property. The taxpayer could perform a 1031 exchange of his investment property for another investment property (usually a residential unit) in the area where the taxpayer wanted to relocate. There would be no tax due on this exchange of investment properties.

The taxpayer could then sell his principal residence and move into the recently acquired property in the new location. The taxpayer would pay no tax on up to \$500,000 of gain from the sale of his principal residence. After living in the newly acquired investment property for two years, the taxpayer could then sell the property and, again, using the principal residence exclusion, avoid paying income tax on up to \$500,000 of the gain. The taxpayer could then use the proceeds from the sale of this investment property (and possibly the proceeds from the sale of his original principal residence) to acquire a new principal residence.

The end result is that the taxpayer was able to realize up to \$500,000 of gain on the sale of his principal residence and up to \$500,000 of gain on the sale of his investment property tax free.

Provisions of the American Jobs Creation Act of 2004, enacted on October 22, 2004, addressed this issue of combining 1031 like-kind exchanges with the exclusion of tax on the sale of a principal residence. As of the date of enactment, the exclusion for gain on the sale of a principal residence no longer applies if the principal residence was acquired

in a like-kind exchange within the past five years. In effect, this requires the taxpayer to hold property acquired in a like-kind exchange for a full five years before it would qualify as a principal residence.¹ This change reduces, but does not eliminate, the attractiveness of combining 1031 like-kind exchanges with the principal residence exclusion. (The holding period is now five years rather than two years).

Discussion

A provision allowing tax-free exchanges of like-kind property was included in the first statutory tax rules for capital gains in the Revenue Act of 1921 and has continued in some form until today. Various restrictions over the years took many kinds of property and exchanges out of its scope, but the rules for real estate, in particular, were broadened over the years by court decisions. The general rationale for allowing tax-free exchanges has been that the investment in the new property is merely a continuation of the investment in the old.

However, in moves to reduce some of the more egregious uses of the rules, the Deficit Reduction Act of 1984 set time limits on completing exchanges and the Omnibus Budget Reconciliation Act of 1989 outlawed tax-free exchanges between related parties.

The most recent change affecting 1031 like-kind exchanges occurred in October 2004, with the enactment of the American Jobs Creation Act of 2004. This Act contained provisions which restricted the application of the principal residence exclusion (IRC §121(d)) if the property had been acquired through a section 1031 like-kind exchange. Under the new regulations, the exclusion for the gain from the sale of a principal residence will not apply if the principal residence had been acquired in a like-kind exchange in which any of the gain had not been recognized within the prior five years. The provision became effective for sales or exchanges after October 22, 2004 (the date of enactment).

The Joint Committee on Taxation (JCT) has identified section 1031 exchanges as tax expenditures. Section 3(3) of the Congressional Budget and Impoundment Control Act of 1974 defines tax expenditures as “those revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability”.²

In effect, tax expenditures may be viewed as spending programs channeled through the tax system.

¹ As opposed to property not acquired through a like-kind exchange which would only have to meet the normal ownership and use tests to qualify for the principal residence exclusion: i.e. that the taxpayer owned the home for at least two years and lived in the home as the taxpayer’s main residence for two years.

² United States Senate, Committee on the Budget, *Tax Expenditures: Compendium of Background Material on Individual Provisions*, p. 2, Dec. 2004.

The JCT estimates that the restrictions on section 1301 like-kind exchanges enacted as part of the American Jobs Creation Act of 2004 will increase federal revenues by \$200 million over the FY2005 through 2014 period.³

Even with these new restrictions, however, the JCT estimates that like-kind exchange transactions will still reduce federal revenues by \$9.1 billion over the next five fiscal years.⁴

³ Joint Committee on Taxation. *Estimated Budget Effects of the Conference Agreement for H.R. 4520, The "American Jobs Creation Act of 2004"*, JCX-69-04, Oct. 2004.

⁴ Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2005-2009*, JCS-1-05, Jan. 2005.