PART IV: NONTAXABLE EXCHANGES

8605. What is a nontaxable exchange? What is the difference between a nontaxable exchange and a tax-free transaction?

In certain circumstances, the IRC permits a taxpayer to obtain new property in order to replace previously held property without recognizing gain on the exchange. This nonrecognition treatment reflects Congress' acknowledgment that, while the taxpayer acquires a new asset in exchange for an existing asset, in substance the taxpayer has not changed economic position.

In a nontaxable exchange, although gain or loss on the disposition of property is not recognized at the time of the exchange, the nonrecognition treatment is only temporary. Thus, when the taxpayer eventually sells the replacement property the taxpayer will then be required to recognize gain or loss.

A direct exchange is not always necessary in order for a transaction to qualify as a nontaxable exchange. For example, in an involuntary conversion, a taxpayer obtains an asset to replace property that was lost. See Q 8611 to Q 8614 for a discussion of the rules applicable in the context of an involuntary conversion.

On the other hand, in a tax-free transaction, the gain or loss is never recognized. For example, within certain limits the gain on the sale of a taxpayer's primary residence is excluded from gross income; and, thus never taxed.[1]

8606. What exchanges of property qualify as like-kind exchanges and nonrecogntion treatment?

IRC Section 1031(a) provides that no gain or loss is recognized if property held for productive use in trade or business or for investment is exchanged solely for property of a "like-kind" to be held for productive use in trade or business or for investment.[2] IRC Section 1031 does not provide a permanent exclusion of gain or loss because the taxpayer's basis in property exchanged transfers to the exchanged property to become the basis of that property.[3] So if the taxpayer subsequently sells the property, the deferred gain or loss would be recognized.

The phrase "like-kind" refers to the nature or character of the property and not to its grade or quality.[4] So, whether real property is improved or unimproved is not relevant because virtually all types of real property are deemed to be of the same nature or character. Perhaps for this reason, the Section 1031 nonrecognition provision is frequently used in connection with exchanges of real property. Interestingly, the regulations equate a leasehold interest with at least 30 years to run as being equivalent to an ownership interest in real property.[5]

1. IRC Sec. 121.
2. IRC Sec. 1031(a)(1).
3. IRC 1031(d).
4. Treas. Reg. §1.1031(a)-1(b).
5. Treas. Reg. §1.1031(a)-1(c); *VIP Industries Inc. v. Commissioner*, TC Memo 2013-157.

Only certain types of property are eligible for nonrecognition treatment under the rules applicable to like-kind exchanges. Exchanges of stock in trade (or other property held primarily for sale) and stocks, bonds, notes, and other securities or evidences of indebtedness or interest are specifically excluded under Section 1031, even though they might otherwise qualify as business or investment property.[1] Additionally, IRC Section 1031(h) specifically excludes exchanges in which at least one of the properties is real property located outside the United States. Similarly, an exchange involving a partnership interest in a real estate partnership is specifically excluded from like-kind exchange treatment.[2]

Though the like-kind exchange rules are well-settled in the area of real property, application of the "like-kind" standard is not so clear with respect to exchanges of personal property. In Revenue Ruling 82-166, the IRS ruled that an exchange of gold bullion (held for investment purposes) for silver bullion (which would also be held for investment purposes) did not qualify as a like-kind exchange, based on the finding that silver and gold are intrinsically different metals and are used in different ways; silver is essentially an industrial commodity while gold is primarily utilized as an investment in itself. Therefore, the IRS reasoned that an investment in one of the metals is fundamentally different from an investment in the other metal.[3] Conversely, the IRS has found that trades of major league player contracts, as well as the exchange of gold bullion for Canadian Maple Leaf gold coins, qualified for like-kind treatment.[4]

8607. What is a taxpayer's basis in property received in a like-kind exchange?

In a transaction qualifying for nonrecognition treatment, the property received takes a carryover or transferred basis from the property given up. In this manner, the unrecognized gain or loss on the property disposed of is deferred by becoming the basis of the acquired property to be recognized later when the acquired property is disposed of in a taxable transaction.[5]

8608. What are the tax consequences if a taxpayer receives consideration other than like-kind property in the exchange?

If a transaction otherwise qualifying for nonrecognition treatment under IRC Section 1031 involves the receipt of money or non-like-kind property ("boot") in addition to the like-kind property received in the exchange, any realized gain on the exchange must be recognized to the extent of the value of the boot received, and the carryover or transferred basis must be adjusted.

> *Example*: Joanne who owns a small business has three delivery vans. In 2014, Joanne transfers one of the delivery vans, which had an adjusted basis of $2,500 and a fair market value of $2,800, to Calin, in exchange for a truck with a fair market value of $2,200, and $600 in cash.
>
> Joanne's realized gain is $300 ($2,200 truck and $600 cash received, or $2,800 minus $2,500 basis). Because the cash is boot, Joanne must recognize gain to the extent of the boot. Joanne's overall gain is $300 and the boot is $600. As a result, Joanne must recognize the entire $300 gain.

1. IRC Sec. 1031(a)(2).
2. IRC Sec. 1031(a)(2)(D).
3. Rev. Rul. 82-166, 1982-2 CB 190.
4. Rev. Rul. 67-380, 1967-2 CB 291; Rev. Rul. 71-137, 1971-1 CB 104; Rev. Rul. 82-96, 1982-1 CB 113.
5. IRC Sec. 1031(d).

As to Joanne's carryover basis, it is increased by the amount of any gain recognized and decreased by the amount of any money received.[1] So in this case, Joanne's basis of $2,500 is increased to $2,800 as a result of the $300 gain. Then that $2,800 basis is decreased by the amount of money received, $600, to $2,200. As a result, Joanne's basis in the truck she received in the exchange is $2,200. So if Joanne were to sell the truck for $2,200 (its fair market value), she would have no gain or loss.[2]

Similarly, if the person who receives the like-kind property assumes a liability that secures the property, the transferor is treated as having received money to the extent of the assumed liability. If the property received in the exchange is also secured by a liability, then the boot deemed received is only the excess, if any, of the liability transferred with the exchange property over the liability assumed on the property received.[3]

Example: Al owns a warehouse with a basis of $160,000, a value of $200,000, and subject to a mortgage of $150,000. He transfers the warehouse to Asher in exchange for an office building with a value of $175,000, which is subject to a $125,000 mortgage.

From a strictly economic perspective, Al's amount realized is the fair market value of the office building, $175,000, plus a net assumption by Asher of $25,000 of liability (Al's property is subject to $150,000 mortgage and Asher's property is subject to a $125,000 mortgage). Thus, Al's realized gain is $40,000 ($200,000 minus $160,000 basis).

Although the transaction is a like-kind exchange, Al must recognize the realized gain to the extent of the boot received. In this case, as a result of the transfer of mortgages, Al is deemed to have receive $25,000 of money ($150,000 minus $125,000).

So of the $40,000 realized gain, Al must recognize $25,000. The balance of the gain, $15,000 is not recognized.

Al's carryover basis is adjusted as follows: The $160,000 basis is increased to $185,000 by the $25,000 of recognized gain. It is then decreased by $25,000, the amount of money Al is deemed to receive. As a result, Al's basis in the office building is $160,000.

Therefore, if Al were to sell the office building for $175,000 (its fair market value), he would recognize $15,000 of gain. So to recap, Al realized $40,000 of gain with respect to the exchange. Of that amount, $25,000 was immediately recognized and $15,000 was deferred.

Realized Gain Computation:

Nonrecognized Portion of Gain	
Amount Realized	$200,000
Basis	$160,000
Total Gain Realized	$40,000
Recognized Gain (Mortgage Boot)	$25,000
Deferred Gain	$15,000

1. IRC Sec. 1031(d).
2. Treas. Reg. §1.1031(d)-1(b).
3. Treas. Reg. §1.1031(b)-1(c).

Recognized Portion Of Gain (Boot)	
Mortgage Given Up	$150,000
Mortgage Taken On	($125,000)
Boot	$25,000
Basis of Building Received	
Carryover Basis From Property Given Up	$160,000
Plus: Gain Recognized	$25,000
Less: Cash Boot Deemed Received	($25,000)
Basis of Building Received	$160,000

8609. Can a taxpayer defer recognition of gain under the like-kind exchange rules if the exchange is made between related parties?

If like-kind property is exchanged between persons who are "related" to each other (as defined in IRC Sections 267(b) or 707(b)(1)), the nonrecognition treatment provided under Section 1031 will not apply if either party disposes of the property received within two years after the exchange.[1]

If such a disposition is made by either party, then both parties must recognize the gain on the exchange in the year of the subsequent disposition.[2] IRC Section 1031(f) (2) contains certain specific exceptions to this rule and a general exception for transactions that the IRS concludes did not have tax avoidance as one of the principal purposes.

As a result, nonrecognition treatment will be permitted if the property was disposed of within two years of the exchange as a result of:

(1) the death of the taxpayer or the related person; or

(2) an involuntary conversion (see Q 8611) if the exchange occurred before the threat of the conversion arose.[3]

IRC Sec. 1031(f)(4) provides that if an exchange is part of a transaction (or series of transactions) structured to avoid the related party rules of Section 1031, the section will not apply at all (except for subsection (f)(4)) and any gain will be recognized in the year of the original sale.

8610. When might a taxpayer want to avoid like-kind exchange treatment?

Like-kind exchange treatment is not elective. Despite this, there are situations where a taxpayer may wish to avoid nonrecognition treatment. If this is the case, in order to avoid application of the like-kind exchange rules, the taxpayer should seek to structure the transaction so that one or more of the requirements under IRC Section 1031 are not met.

1. IRC Sec. 1031(f).
2. IRC Sec. 1031(f)(1).
3. IRC Sec. 1031(f)(2).

There are many reasons why a taxpayer may wish to recognize gain in the current year rather than deferring it until some point in the future. For example, a taxpayer may wish to recognize gain in order to obtain a higher basis in the property for depreciation purposes.

Example: Asher owns a warehouse with a fair market value of $200,000 and a basis of $40,000. In a like-kind exchange of the warehouse for an office building of equal value will result in Asher having a carryover basis of $40,000 in the office building. However, if the exchange did not qualify as a like-kind exchange, Asher would recognize a gain of $160,000 ($200,000 minus $40,000). However, due to the recognition of gain, Asher's basis in the office building would be $200,000. Thus, with a higher basis, Asher would be entitled to greater depreciation deductions.

Additionally, if the taxpayer has a substantial amount of capital loss, a recognized gain would be offset by such loss (see Q 8575) or if taxpayer's current income tax rate is expected to rise in the future. See Q 8561 for a discussion of the current capital gains rates and their interaction with a taxpayer's income tax rates.

Planning Point: For taxpayers who anticipate that their capital gains rate will increase (perhaps from the current low of 0 percent (in 2008-2014 for taxpayers in the 10 or 15 percent ordinary income tax brackets) to as much as 23.8 percent when the investment income tax (see Q 8580 and Q 8597) is applied), deferring capital gains in a nontaxable exchange could actually cause their tax liability to increase. In 2013 and beyond, the long-term capital gains tax rate is 20 percent for high income taxpayers (but remains at 0 percent for taxpayers in the 10 and 15 percent tax brackets).

8611. What are the tax consequences of an involuntary conversion?

IRC Section 1033 applies to cases where property is compulsorily or involuntarily converted. This provision recognizes that a taxpayer who has suffered an involuntary conversion has experienced an economic hardship and may not have the ability to pay taxes on any gain resulting from the conversion. This is because any proceeds in excess of the taxpayer's basis in the converted property would generate taxable gain. Thus, IRC Section 1033 postpones recognition of the gain to the extent the proceeds obtained in the conversion, whether through insurance or otherwise, is reinvested in replacement property (see Q 8612).[1]

An "involuntary conversion" may be the result of the destruction of property (whether in whole or in part, see Q 8614 for a discussion of partial conversions), the theft of property, the seizure of property, the requisition or condemnation of property, or the threat or imminence of requisition or condemnation.

On the other hand, he taxpayer is required to recognize any gain that exceeds the amounts reinvested in replacement property following the involuntary conversion.[2]

Example: Patrick received $500,000 in insurance proceeds when his warehouse with an adjusted basis of $100,000 was destroyed in a hurricane. If Patrick decided to retire and keep the insurance proceeds, he would have a gain of $400,000 (it is as if he sold the warehouse to the insurance company for $500,000) However, in evaluating his financial situation, Patrick decides to downsize his business and purchase a new warehouse for $350,000. Because Patrick reinvested $150,000 *less* than he actually received, he must recognize $150,000 of the $400,000 gain.

1. IRC Sec. 1033(a).
2. IRC Sec. 1033(a)(2).

Planning Point: All the details of an involuntary conversion of property at a gain (including information about the replacement of the converted property, a decision not to replace it, or the expiration of the period for replacement) must be reported in the return for the year or years in which any of the gain is realized.[1]

Section 1033 applies only with respect to gains. If a taxpayer experiences a loss as a result of an involuntary conversion, Section 1033 is inapplicable and the loss is recognized or not recognized in accordance with the general rules applicable to loss recognition. See, for example, Q 8649 to Q 8660, which explain the rules applicable when a taxpayer has experienced a casualty loss.

8612. How does the type of property into which the lost or destroyed property is converted into impact whether the taxpayer can claim non-recognition treatment as the result of an involuntary conversion?

Conversion into Similar Property

Whether or not the taxpayer is required to recognize gain resulting from an involuntary conversion of property depends upon the type of property into which the lost or destroyed property is converted.[2] If, as explained below, the replacement property is similar or related in service or use with the lost or destroyed property, no gain is recognized (losses are always recognized). For nonrecognition treatment to apply, no election is required.

The determination of whether property is similar for purposes of IRC Section 1033 is not the same for determining whether property is "like-kind" property for purposes of IRC Section 1031. The taxpayer's *use* of the replacement property must be similar to the use of the converted property.[3] For example, if a taxpayer's principal residence is replaced by rental property, it would not be considered a similar use.

In the business context, the following factors are relevant in determining whether the taxpayer has replaced converted property with similar property:

(1) Whether the properties provide a similar service to the taxpayer;

(2) The nature of the business risks connected with the properties; and

(3) The demands of the properties upon the taxpayer, including management, required services or relations to tenants.[4]

Conversion into Money or Dissimilar Property

The result is different when the original property is converted into money or dissimilar property. In such cases the proceeds arising from the disposition of the converted property must (within the time limits specified, see Q 8613) be reinvested in similar property (as described above)

1. Treas. Reg. §1.1033(a)-2(c)(2).
2. IRC Sec. 1033(a).
3. Rev. Rul. 70-466, 1970-2 CB 165.
4. Rev. Rul. 64-237, 1964-2 CB 319.

in order to avoid recognition of any gain realized.[1] If the taxpayer reinvests the entire proceeds into replacement property, no gain will be recognized. However, if the taxpayer only invests part of the proceeds, the taxpayer can elect to recognize the gain only to the extent that the cost of the replacement property exceeds the reinvested proceeds. Obviously, if the taxpayer fails to make the election the entire gain would be recognized.[2]

> *Example*: In 2014, a warehouse Asher used in his trade or business was totally destroyed by fire. At the time of the destruction of the warehouse, the warehouse had an adjusted basis of $100,000. The insurance company promptly paid Asher $500,000 for the loss. As a result, Asher realizes a gain of $400,000. Later that year, Asher purchases a new warehouse for $350,000. Thus, the insurance proceeds exceeded the cost of the replacement property by $150,000 ($500,000 minus $350,000). If Asher fails to make an election pursuant to IRC Section 1033(a)(2), the entire realized gain, $400,000, would be included in his gross income. On the other hand, if Asher makes the election, only $150,000 (the amount of the proceeds he did not reinvest) of the $400,000 gain would be included in gross income.

8613. Is a taxpayer who has an involuntary conversion into money required to replace the lost or destroyed property within a certain amount of time to qualify for nonrecogntion treatment?

In order to qualify for nonrecognition treatment under IRC Section 1033, the taxpayer must replace the property that has been involuntarily converted within a two-year period. The time period begins to run upon the date of the disposition of the converted property or, if the conversion results from condemnation of the property, the date when the condemnation became imminent.[3]

If a taxpayer's principal residence is destroyed as a result of an involuntary conversion that takes place in a federally-declared disaster area, the time period for purchasing replacement property is extended to four years.[4]

8614. Must a taxpayer's property be completely destroyed to qualify for nonrecognition treatment under the rules for involuntary conversions?

The involuntary conversion of a taxpayer's property does not need to occur as a result of one sudden event (e.g., a natural disaster) in order for the taxpayer to qualify for nonrecognition treatment under IRC Section 1033.[5] For example, the IRS ruled that the progressive pollution of a taxpayer's water supply with salt water constituted an involuntary conversion for purposes of IRC Section 1033.[6] Similarly, the IRS has ruled that chemical contamination of property, which did not destroy the property per se, but made it unsafe for its intended use, qualified as a Section 1033 "destruction."[7]

1. IRC Sec. 1033(a)(2)(A).
2. Treas. Reg. §1.1033(a)-2(c)(1).
3. IRC Sec. 1033(a)(2)(B).
4. IRC Sec. 1033(h).
5. Rev. Rul. 59-102, 1959-1 CB 200.
6. Rev. Rul. 66-334, 1966-2 CB 302.
7. Rev. Rul. 89-2, 1989-1 CB 259.

Despite this, if the taxpayer disposes of partially destroyed property that could have been repaired, nonrecognition treatment under IRC Section 1033 could be denied. This is because the decision not to repair is "voluntary" as compared to an "involuntary conversion." For example, the Tax Court denied nonrecognition treatment when the taxpayer sold a ship damaged in a collision and invested both the sale proceeds and insurance proceeds in another vessel. Because the taxpayer could have used the insurance proceeds to repair the ship, but instead *chose* to purchase a second ship, the conversion was not involuntary. Although the court recognized that it may have been a sound business decision to replace rather than repair, having the choice negated the possibility that the conversion was involuntary. The taxpayer was, therefore, required to recognize all the gain realized in the transaction.[1]

Conversely, the IRS has ruled privately that when the cost of repairs exceeded the value of the property prior to its destruction, there was no practical alternative other than selling the property and purchasing replacement property. Under these circumstances, the taxpayer was entitled to nonrecognition treatment under IRC Section 1033 although, theoretically, the property *could* have been repaired.[2]

Based on these rulings, a taxpayer whose property is partially destroyed will generally qualify for nonrecognition treatment under IRC Section 1033 if the economics of selling the property outweigh the cost of repairing it.

8615. Under what circumstances does all or part of the gain from the sale of a personal residence qualify for nonrecognition treatment?

As a general rule, taxpayers may exclude up to $250,000 ($500,000 for married taxpayers filing jointly) of gain on the sale of a principal residence.[3] In order to qualify for this exclusion, the taxpayer must have owned and used the residence as the taxpayer's principal residence for two of the preceding five years.[4]

Planning Point: Note that the Internal Revenue Code does not contain a definition of the term "principal residence." IRS guidance advises that, whether or not property is used by the taxpayer as his principal residence depends on all the facts and circumstances in each case, including the good faith of the taxpayer. Determinative factors include the taxpayer's place of employment, place of abode of family members, and the address listed on taxpayer's tax returns.[5]

The use does not need to be continuous in order to satisfy this requirement, and short absences are disregarded for purposes of making the calculation. Thus, for example, a taxpayer who owns his principal residence for two years and takes a two-month vacation each summer will qualify for the Section 121 exclusion despite the fact that he was not physically present in his principal residence for a full 24 months.[6]

1. *Willis v. Commissioner*, 41 TC 468 (1964).
2. Let. Rul. 8928011.
3. IRC Sec. 121(b).
4. IRC Sec. 121(a).
5. Treas. Reg. §1.121-1(b)(2); IRS Chief Counsel Memo No. 200947036 (11-20-2009).
6. See IRS Pub. 523.

The taxpayer may only take advantage of this exclusion once within each two-year period.[1]

> *Example*: Shannon and Mike sell their home in January 2013, excluding $50,000 of gain under IRC Section 121. In the same month, they purchase a new primary residence. Less than two years later, in August 2014, they sell that primary residence. Any gain on the 2014 sale cannot be excluded because they have already excluded gain from the sale of one principal residence under IRC Section 121 within a two-year period. The fact that their 2013 exclusion was only $50,000 of a possible $500,000 total exclusion is irrelevant.

However, in some cases, taxpayers may qualify for a reduced exclusion (i.e., a proportionate amount of the potential exclusion) if they sell multiple principal residences during a two-year period because of (a) a change in place of employment; (b) health problems or (c) certain unforeseen circumstances (see Q 8616 for a discussion of these exceptions).[2]

8616. Are there circumstances in which a taxpayer can exclude the gain on the sale of a personal residence even though the taxpayer fails to meet the requirements otherwise required for exclusion treatment?

If a taxpayer fails to meet the ownership and use requirements, or sells multiple primary residences within the two-year period, a portion of the exclusion (as discussed below) may still be available if the primary residence is sold for reasons that were *primarily* caused by a change in the taxpayer's place of employment, health, or, to the extent provided in regulations, unforeseen circumstances.[3] In determining a taxpayer's primary reason for selling a primary residence, the following factors are considered:

(1) Whether the sale and the circumstances giving rise to the sale are proximate in time;

(2) Material changes in the suitability of the property as the taxpayer's primary residence;

(3) Impairments to the taxpayer's financial ability to maintain the property;

(4) Whether the taxpayer has used the property as his residence during the period of ownership;

(5) Whether or not the circumstances giving rise to the sale are reasonably foreseeable at the time when the taxpayer began using the property as his or her primary residence;

(6) Whether or not the circumstances giving rise to the sale occur during the period of the taxpayer's ownership and use of the property as his or her principal residence.[4]

For taxpayers claiming a Section 121 exclusion based on a change in place of employment, a safe harbor applies if the change in employment occurs during the period of the taxpayer's ownership and use of the property as a principle residence and the taxpayer's new place of employment is at least 50 miles from the residence that was sold.[5]

1. IRC Sec. 121(b)(3).
2. See IRS Pub. 523, above.
3. IRC Sec. 121(c)(2).
4. Treas. Reg. §1.121-3(b).
5. Treas. Reg. §1.121-3(c)(2).

Similarly, for taxpayers claiming the exclusion based on health reasons, a safe harbor exists for taxpayers whose physician has recommended a change in residence for health reasons.[1]

The exception for a sale based on "unforeseen circumstances" may be met based on any of the following specific events:

(1) An involuntary conversion of the residence;

(2) Natural or man-made disasters, or acts of war or terrorism, resulting in a casualty to the residence;

(3) The death of the taxpayer;

(4) Loss of employment resulting in eligibility for unemployment compensation;

(5) Change in employment that results in the taxpayer's inability to pay housing costs and reasonable basic living expenses for the taxpayer's household;

(6) Divorce or legal separation; or

(7) Multiple births resulting from the same pregnancy.[2]

The taxpayer does *not* qualify for the exclusion based on unforeseen circumstances if the unforeseen circumstance is an *improvement* in the taxpayer's financial condition.[3]

> *Example*: In April 2013 George buys a house that he uses as his principal residence. He sells it in October 2014 because the house has greatly appreciated in value and mortgage rates have substantially decreased, making a bigger house affordable. The specific event safe harbors described above do not apply. Under the facts and circumstances, the primary reasons for the sale of the house--the changes in George's house value and in the mortgage rates--are an improvement in his financial circumstances. However, an improvement in financial circumstances, even if the result of unforeseen circumstances, does not qualify for the reduced maximum exclusion by reason of unforeseen circumstances under IRC section 121(c)(2).[4]

For purposes of determining the reduced exclusion, the maximum amount of gain that would have been excluded but for the premature sale of the primary residence is multiplied by a fraction. The numerator of the fraction equals the shorter of (1) the aggregate periods during the five-year period ending on the date of the sale or exchange that the property has been owned or used by the taxpayer as a principal residence, or (2) the period after the date of the most recent prior sale or exchange by the taxpayer to which the two-year limitation applied and the date of the sale or exchange. The denominator equals two years.[5]

> *Example*: On July 2, 2010, Ashley, a single taxpayer, purchased her first primary residence for $150,000. More than two years later, on August 15, 2012, Ashley sold the home for $200,000. Because she met all the requirements of IRC Section 121, Ashley excluded the entire amount of her gain. On September 15, 2012,

1. Treas. Reg. §1.121-3(d)(2).
2. Treas. Reg. §1.121-3(e)(2).
3. Treas. Reg. §1.121-3(e)(1).
4. Treas. Reg. §1.121-3(e)(4), Example 8.
5. IRC Sec. 121(c)(1).

Ashley purchased a new primary residence for $250,000. Nine months later, on June 15, 2013, Ashley sold the new primary residence for $275,000 because she lost her job and had to take a new job in a different state.

Although the sale of the new primary residence does not qualify for the full exclusion because Ashley used and owned the home for only nine months, the unforeseen circumstance of losing her job that necessitated her relocation qualify her for the exclusion. Applying the partial exclusion formula, her $250,000 maximum exclusion (single taxpayer) is multiplied by 9/24, or $93,750. This is because, per the formula, the numerator is the lesser of the time between the date of the sale of the previous home (August 15 or ten months to the June 15 sale date) or the time she used and owned the latter residence as her primary residence and the date of the sale (September 15 or nine months until the June 15 sale date). For that reason, Ashley may exclude the entire amount of her gain ($25,000) because it was less than the reduced exclusion amount ($93,750).

If the taxpayer is mentally or physically incapable of caring for himself, and the taxpayer owned and used the property as a principal residence for an aggregate of one year during the five-year period ending on the date of the sale or exchange, an exception to the use requirement applies. Such a taxpayer will be *treated as using* the property during any time within the five-year period that the taxpayer *owns* the property and resides in a facility (including a nursing home) licensed by the state or a political subdivision to care for such an individual.[1]

8617. How much gain is a taxpayer permitted to exclude from income on the sale of a personal residence? How is the exclusion calculated?

Generally, an individual who sells a principal residence may elect to exclude up to $250,000 of gain from gross income.[2] However, married couples filing jointly may exclude up to $500,000 if they meet the following requirements:

(1) they must file a joint return for the taxable year of the sale or exchange;

(2) *either* spouse must meet the ownership requirements outlined in Q 8615;

(3) *both* spouses must meet the use requirements outlined in Q 8615; and

(4) *neither* spouse is ineligible to use the exclusion because he had used the exclusion in the two-year period ending on the date of the sale or exchange.[3]

8618. If a taxpayer has multiple residences, which residence qualifies as the principal residence in determining whether exclusion of gain upon sale is permissible?

Under IRC Section 121, an individual may elect to exclude up to $250,000 ($500,000 for married couples) on the sale of a principal residence (see Q 8615 and Q 8617). This exclusion is only available with respect to the taxpayer's principal residence. If a taxpayer has multiple residences, the taxpayer may still only exclude gain from the sale of the residence that is considered to be the principal residence.

1. IRC Sec. 121(d)(7).
2. IRC Sec. 121(b).
3. IRC Sec. 121(b).

Whether or not a residence is considered the taxpayer's principal residence for purposes of the Section 121 exclusion requires a traditional facts and circumstances analysis.[1] Assuming that the taxpayer alternates between two or more residences, the residence the taxpayer resides at for the majority of the time generally will be considered the principal residence. Additionally, other factors considered in making the determination, including the following nonexhaustive list:

(1) the taxpayer's place of employment;

(2) the principal place of residence of the taxpayer's family members;

(3) the address listed by the taxpayer on his or her driver's license, tax returns, car registration and voter registration card;

(4) the taxpayer's mailing address for bills and correspondence;

(5) the location of the taxpayer's bank; and

(6) the location of religious organizations and recreational clubs with which the taxpayer is affiliated.[2]

In a case involving two different residences in different states, the Tax Court held that the taxpayer's principal residence was the one in which the taxpayer spent a substantial amount of time, i.e., threw family parties and celebrated holidays, even though the second residence address appeared on the taxpayer's tax returns over the years. In addition, the Tax Court rejected the IRS' contention that the second residence in the other state was the taxpayer's principal residence because the taxpayer (1) owned a business in that state and (2) held a liquor license that required state residency.[3]

With respect to multiple residences, it is possible that over a five year period, a taxpayer may not spend the majority of days in any one residence for the two required years. Thus, he or she would not be able to take advantage of the exclusion due to the failure to meet the two-year use requirement (see Q 8615).

Example: In the past five years, Jim and Nancy alternated between homes in Michigan, Florida and New York. During that five-year period, they spent more time in the Florida residence than in any other home. *However*, within that period, there was only one year in which they spent the majority of days in Florida. Therefore, even though their primary residence is in Florida, they will be unable to exclude gain on its sale under Section 121 because they will be unable to satisfy the two-year use requirement.[4]

Although not expressly addressed in the regulations, if the taxpayers were able to satisfy the two-year use requirement for more than one residence during the relevant five year period, they should be able to exclude gain from the sale of *either* residence.

1. Treas. Reg. §1.121-1(b)(1).
2. Treas. Reg. §1.121-1(b)(2).
3. *Wickersham v. Commissioner*, TC Memo 2011-178.
4. See *Guinan v. U.S.*, 2003-1 USTC 50,475 (2003).

Example: During the previous five year period, Jim and Nancy spend the majority of their days in Florida during years one and two. In years three and five, they spend the majority of their days in Michigan. If they choose to sell the Florida or Michigan residence, they will have satisfied the two-year use requirement for both residences and, assuming the other requirements are met, they should be able to exclude the gain on the sale of *either* residence as their principal residence.

8619. Is a taxpayer permitted to exclude gain on the sale of a principal residence used partially for business purposes?

Business Portion of Property Separate from Taxpayer's Dwelling Unit

If a portion of a piece of property is used as the taxpayer's principal residence and another portion of that same property is used for business purposes, the taxpayer is required to allocate any gain on the sale of the property between the residential and business portions *if* the portion used for business is separate from the taxpayer's "dwelling unit."

"Dwelling unit," for this purpose, is defined in IRC Section 280A (a house, apartment, condominium, mobile home, boat or similar property) except appurtenant structures (such as a detached garage, barn or stable located on the same land) are excluded for purposes of Section 121.[1] Only the gain from the portion of the property that is used as the taxpayer's primary residence (dwelling unit) may be excluded under Section 121.[2]

Example: Joe operates a dock installation business on a small lake. Rather than renting a separate office space, Joe uses a barn located 100 feet from his home (the "dwelling unit") to store and repair any broken portions of the docks, as well as for general office space. During the past ten years, the barn has been his place of business and the home has been his primary residence. In year 11, Joe sells the entire property for $360,000. Because the barn he used for his business is separate from his dwelling unit, he must allocate the basis of the property between the barn and the home.[3]

One way to allocate basis is based on physical size. To this point, when Joe acquired the property, the purchase price and basis for the entire property was $300,000. Physically, the home occupies 2/3rds of the property and the barn occupies 1/3rd of the property. Thus, based on size, the basis of home should be $200,000 and the basis of the barn should be $100,000. However, as a result of depreciation deductions Joe claimed on the barn, the basis had been decreased to $45,000.

As to the sale of the property in year 11, Joe's overall economic gain is $60,000 ($360,000 selling price less $300,000 original purchase price). Based on the same allocation method described above, the gain should be allocated $40,000 to the home and $20,000 to the barn. As to the gain allocated to the home, since Joe meets the requirements of IRS Section 121, the entire amount of that gain is excluded from gross income.

On the other hand, $20,000 of the gain is attributable to the barn. None of the gain attributable to the barn is excludible pursuant to IRC Section 121. Thus, it is as if Joe sold the barn for $120,000 (allocating 2/3rds of the $360,000 sales price to the barn). In other words, Joe's gain would be computed in the same way as if he had simply sold the barn. Thus, because his basis in the barn is $45,000, Joe's taxable gain would be computed as follows:

1. Treas. Reg. §1.121-1(e)(1), IRC Sec. 280A(f)(1)(A).
2. Treas. Reg. §1.121-1(e)(1).
3. Treas. Reg. §1.121-1(e)(3).

Amount Realized	$120,000
Original Basis	$100,000
Capital Gain	$20,000 (amount of gain attributable to the appreciation of the barn from $100,000 to $120,000)
Adjusted Basis	$45,000 ($100,000 minus $55,000 depreciation deductions)
Unrecap Sec 1250 gain	$55,000 ($100,000 original basis minus adjusted basis).

Business Portion of Property Not Separate from Taxpayer's Dwelling Unit

Allocation is only required if the property used for business purposes is separate from the taxpayer's principal residence. However, if a taxpayer uses a *non-separate* portion of the residence for business and claims a depreciation deduction as a result of such use, the taxpayer may be required to recognize unrecaptured gain under IRC Section 1250.[1]

> *Example*: Kacey is a lawyer and has used three rooms in her residence as her law office between 2008 and 2014. Over this period, she claimed depreciation deductions totaling $10,000. In 2014, she sells the house for a $30,000 gain. She has no other capital gains or losses for the year. She must recognize $10,000 of the gain (an amount equal to her depreciation deductions) but may exclude the remaining $20,000 because she is not required to allocate gain between residential and business use property under Treasury Regulation Section 1.121-1(e)(1). If Kacey had not been entitled to claim depreciation deductions with respect to the business use of the house, the entire $30,000 of gain would be excluded from gross income.[2]

8620. Can a taxpayer exclude gain on the sale of vacant land under the same principles that apply to excluding gain on the sale of a principal residence?

A taxpayer may be able to exclude gain on a sale of vacant land made within two years of the sale of a residence if certain requirements are met. A sale of vacant land can piggy back onto the sale of a taxpayer's principal residence provided (a) the vacant land is adjacent to a dwelling unit used by the taxpayer as the taxpayer's principal residence; (b) the taxpayer owned and used the vacant land as part of the taxpayer's principal residence; (c) the taxpayer sells the dwelling unit in a sale that meets the requirements of IRC Section 121 within two years before or two years after the date of the sale of the vacant land; and (d) the requirements of IRC Section 121 must have been otherwise met with respect to the land.[3]

For purposes of excluding the gain on the sale of the vacant land, the sale of the land and the dwelling is treated as a single sale. Therefore, the taxpayer's $250,000 ($500,000 for married couples) exclusion applies to the combined sale. If the sales take place in different tax years, gain on the sale of the dwelling unit is taken into account and excluded first. If after that, there is any of exclusion amount remaining it will be applied to the sale of the vacant land.[4]

1. Treas. Reg. §1.121-1(e)(1).
2. Treas. Reg. §1.121-1(e)(4), Ex.6.
3. Treas. Reg. §1.121-1(b)(3)(i).
4. Treas. Reg. §1.121-1(b)(3)(ii)(A).

Example: In 2013, Asher, a single taxpayer who owns a primary residence with adjacent land sells the primary residence for $400,000 with respect to which there is a $100,000 gain. Assuming Asher meets all the requirements of IRC Section 121, the entire $100,000 gain is excluded from gross income. Because a single taxpayer can exclude up to $250,000 of gain, there is $150,000 of remaining available exclusion. In 2014, Asher sells the adjacent land for $300,000 and realizes a $200,000 gain. Again, assuming the requirements of IRC Section 121 are met, Asher can exclude $150,000 of the $200,000 gain. This is because the sale of the home and the vacant land are treated as a single transaction. Since the total gain was $300,000 ($100,000 on the home and $200,000 on the vacant land), the $100,000 gain on the sale of the home is excluded, $150,000 of the gain on the land is excluded and $50,000 of the gain in excess of $250,000 is included in gross income.

If the taxpayer sells the dwelling unit in a tax year that begins *after* the tax year in which the vacant land is sold, and *after* the due date for the tax return for that earlier year, the taxpayer must include in gross income any gain on the sale of the vacant land in the year it is sold. Then upon the later sale of the dwelling unit, the taxpayer is permitted to claim the appropriate IRC Section 121 exclusion with respect to the vacant land by filing an amended return.[1]

8621. In the case of an involuntary conversion of a primary residence, how does the nonrecognition treatment under IRC Section 1033 and the exclusion of gain under IRC Section 121 interact?

If a taxpayer's principal residence is destroyed and the proceeds from insurance are used to purchase a replacement residence, IRC Section 1033 and IRC Section 121 interact as follows:

1. For purposes of determining potential gain for purposes of IRC Section 1033, the amount realized is the fair market value of the relinquished property;

2. Next, the amount of gain that would have been excluded pursuant to IRC Section 121 is subtracted from that amount; and

3. Gain would be recognized to the extent that amount computed pursuant to 2), above exceeded the cost of a replacement home.[2]

Example: In 2014, Asher, a single taxpayer has a primary residence with a fair market value of $600,000 and a basis of $250,000. In a storm, Asher's home is totally destroyed. Asher uses $300,000 of the $600,000 insurance proceeds to purchase a new primary residence. Asher's regular realized gain would be $350,000 ($600,000 minus $250,000). Of that gain, since Asher is a single taxpayer, he may exclude $250,000.

Step 1 and Step 2. $600,000 insurance proceeds minus the $250,000 gain Asher can exclude pursuant to IRC Section 121 equals $350,000.

Step 3. Asher used $300,000 of the insurance proceeds to purchase a replacement home. However, since $350,000 (Step 1 and Step 2 amount) exceeds that amount by $50,000, the latter amount is included in gross income.[3]

1. Treas. Reg. §1.121-1(b)(3)(ii)(C).
2. IRC Sec. 121(d)(5)(B).
3. Rev. Proc. 2005-14, 2005-7 IRB 492.

Asher's basis should be computed as follows:

1. Original basis in home - $250,000
2. Gain recognized - $50,000
3. Gain Excluded - $250,000
4. New Basis - $550,000 (1 plus 2 plus 3).

Thus, Asher's new home has a fair market value of $300,000 and a basis of $550,000. The difference between the fair market value of the home and the basis reflects the $250,000 of excluded IRC Section 121 gain. In essence, with this higher basis, Asher's exclusion is preserved. So, if Asher sells the home for up to $550,000, there would be no realized gain.

8622. Does an exchange of corporate stock for corporate stock qualify for nonrecognition treatment?

Pursuant to IRC Section 1036, common stock in a corporation exchanged for common stock in the same corporation is tax-free. The nonrecognition rules of IRC Section 1036 apply to exchanges of common stock in the same corporation, even though the stocks are of a different class and have different voting, preemptive, or dividend rights.[1] Nonrecognition also applies to an exchange of preferred stock for preferred stock in the same corporation. However, gain or loss may be recognized if cash or other property is also received. This treatment applies both to exchanges between an individual shareholder and the corporation and to exchanges between two shareholders. Such an exchange is treated in substantially the same manner as a "like-kind" exchange (see Q 8606 to Q 8610).

Finally, the exchange of stock in different corporations and exchanges of common stock for preferred stock do *not* qualify for nonrecognition treatment even if the shares of stock are similar in all other aspects.[2]

8623. What are the requirements to exclude 50 percent of the gain on the sale of qualified small business stock?

If certain requirements are met, a noncorporate taxpayer (including certain partnerships and S corporations) may exclude from gross income 50 percent of any gain from the sale or exchange of qualified small business stock held for more than five years.[3] With certain exceptions, a qualifying small business is:

- A C Corporation (excludes an S Corporation)
- Any trade or business other than one involving the performance of legal, health, engineering, architecture, account, actuarial services, etc. or any other trade or business in which the principal asset is the skill or reputation of its employees

At least 80 percent of its assets by value must be used in the active conduct of a qualified trade or business

1. Rev. Rul. 72-199, 1972-1 CB 228, Treas. Reg. §1.1036-1.
2. IRC Secs. 1036, 1031(a), Treas. Reg. §1.1036-1.
3. IRC Sec. 1202, as amended by ARRA 2009. See also IRC Sec. 1(h)(7).

The aggregate amount of eligible gain from the disposition of qualified small business stock issued by one corporation that may be taken into account in a tax year may not exceed the greater of the following amounts:

(a) $10,000,000 ($5,000,000 in the case of married taxpayers filing separately) reduced by the aggregate amount of such gain taken into account in prior years; *or*

(b) 10 times the aggregate bases of qualified stock of the issuer disposed of during the tax year.

For purposes of the limitation in (b), the adjusted basis of any qualified stock will not include any additions to basis occurring after the stock was issued.[1]

Gain realized by a partner, shareholder, or other participant that is attributable to a disposition of qualified small business stock held by a pass-through entity (i.e., a partnership, S corporation, regulated investment company, or common trust fund) is eligible for the exclusion if the entity held the stock for more than five years, and if the taxpayer held an interest in the pass-through entity at the time of acquisition and at all times since the acquisition of the stock.[2]

Significantly, a taxpayer is not entitled to the section 1202 50 percent exclusion as well as the reduced capital gains rates (15 percent and 20 percent). Instead, the tax rate is subject to a maximum rate of 28 percent. Coupled with the 50 percent exclusion, the actual maximum effective rate on the gain is 14 percent.

Any gain excluded under IRC Section 1202 by a married couple filing jointly must be allocated equally between the spouses for purposes of claiming the exclusion in subsequent tax years.[3]

Special rules apply to IRC Section 1202 stock for alternative minimum tax purposes (see Q 8551 to Q 8555 for a discussion of the AMT). An amount equal to 7 percent of the amount excluded from gross income for the taxable year under IRC Section 1202 will be treated as a preference item.[4]

8624. How does an offsetting short position impact a taxpayer's eligibility to exclude 50 percent of the gain on the sale of qualified small business stock?

Under IRC Section 1202, if a taxpayer has an *offsetting short position* with respect to any qualified small business stock, the otherwise applicable 50 percent exclusion (see Q 8623) is unavailable unless:

(a) the stock was held for more than five years as of the date of entering into the short position; *and*

1. IRC Sec. 1202(b).
2. IRC Sec. 1202(g).
3. IRC Sec. 1202(b)(3)(B).
4. IRC Sec. 57(a)(7).

(b) the taxpayer elects to recognize gain as if the stock were sold at its fair market value on the first day the offsetting position was held.[1]

A taxpayer has an "offsetting short position" with respect to any qualified small business stock if the taxpayer (or a related party) has (a) made a short sale of substantially identical property, (b) acquired an option to sell substantially identical property at a fixed price, or (c) to the extent expected to be provided in future regulations, entered into any other transaction that substantially reduces the taxpayer's risk of loss from holding the qualified small business stock.[2]

Taxpayers should note that certain offsetting short positions (e.g., a short sale) may also result in constructive sale treatment under the rules of IRC Section 1259. While the IRC does not specifically address the impact of IRC Section 1259 on IRC Section 1202, it would appear that if the requirements of IRC Section 1202(j) are otherwise met, the exclusion provided under IRC Section 1202 would not be lost merely because the taxpayer may be required to immediately recognize gain under IRC Section 1259.

8625. Under what circumstances may a noncorporate taxpayer roll over gain from the sale or exchange of qualified small business stock that is held for six months or more?

Generally, a noncorporate taxpayer, including certain partnerships and S corporations, may elect to roll over gain from the sale or exchange of qualified small business stock held more than six months to the extent that the taxpayer purchases other qualifying small business stock within 60 days of the sale of the original stock.[3]

If the taxpayer elects to roll over gain on the sale of qualified small business stock, gain will be recognized only to the extent that the amount realized on the sale exceeds (1) the cost of any qualified small business stock purchased by the taxpayer during the 60-day period beginning on the date of the sale, reduced by (2) any portion of such cost previously taken into account under this rollover provision. The rollover provisions of IRC Section 1045 will not apply to any gain that is treated as ordinary income.[4]

Rules similar to those applicable to rollovers of gain by an individual from certain small business stock[5] will apply to the rollover of such gain by a partnership or S corporation.[6] Thus, for example, the benefit of a tax-free rollover with respect to the sale of small business stock by a partnership will flow through to an "eligible partner"—meaning a partner who is not a corporation and who held his partnership interest at all times during which the partnership held the small business stock.[7] (A similar rule applies to S corporations and their shareholders.)[8]

1. IRC Sec. 1202(j)(1).
2. IRC Sec. 1202(j)(2).
3. See IRC Sec. 1045(a).
4. IRC Sec. 1045(a).
5. IRC Sec. 1202.
6. IRC Sec. 1045(b)(5).
7. See Treas. Regs. §§1.1045-1(b)(1), 1.1045-1(g)(3)(i).
8. General Explanation of Tax Legislation Enacted in 1998 (JCS-6-98), p. 167 (the 1998 Blue Book).

For the rules regarding (1) the deferral of gain on a partnership's sale of qualified small business stock followed by an eligible partner's acquisition of qualified replacement stock, and (2) the deferral of gain on a partner's sale of qualified small business stock distributed by a partnership, see Treasury Regulation Section 1.1045-1.[1]

Any gain not recognized because of a rollover of qualified small business stock will be applied to reduce (in the order acquired) the basis for determining gain or loss of any qualified small business stock purchased by the taxpayer during the 60-day rollover period.[2]

Ordinarily, the holding period of qualified small business stock purchased in a rollover transaction will include the holding period of the stock sold; but for purposes of determining whether the nonrecognition of gain applies to the stock that is sold, the holding period for the replacement stock begins on the date of purchase. In addition, only the first six months of the taxpayer's holding period for the replacement stock will be taken into account for purposes of determining whether the active business requirement is met.[3]

Practice Point: The taxpayer must make an election under IRC Section 1045 by the due date (including extensions) for filing the income tax return for the taxable year in which the qualified small business stock is sold.[4] The election is made by (1) reporting the entire gain from the sale of qualified small business stock on Schedule D; (2) writing "IRC Section 1045 rollover" directly below the line on which the gain is reported; ***and*** (3) entering the amount of the gain deferred under IRC Section 1045 on the same line as (2), above, as a loss, in accordance with the instructions for Schedule D.[5]

If a taxpayer has more than one sale of qualified small business stock in a taxable year that qualifies for the IRC Section 1045 election, the election can be made for any one or more of those sales. An IRC Section 1045 election is revocable only with the Commissioner's consent.[6]

8626. Under what circumstances can a taxpayer roll over the gain from a sale of stock in a specialized small business investment company?

Individual taxpayers and C corporations that invest in a specialized small business investment company (SSBIC, see below) may elect to roll over capital gain (within limits) on publicly-traded securities sold within 60 days of the SSBIC purchase. In order to defer the taxation of gain from such a sale, the individual or corporation must use the proceeds from the sale to purchase common stock or a partnership interest in a SSBIC within 60 days of the date of sale.[7]

The amount of gain that may be rolled over for any taxable year by an individual is limited to the lesser of (a) \$50,000 or (b) \$500,000, reduced by any gain previously excluded under this rollover provision. Thus, the most an individual may roll over during his lifetime

1. TD 9353, 2007-2 CB 721.
2. IRC Sec. 1045(b)(3).
3. IRC Secs. 1045(b)(4), 1223(15).
4. Rev. Proc. 98-48, 1998-2 CB 367.
5. Rev. Proc. 98-48, 1998-2 CB 367.
6. Rev. Proc. 98-48, 1998-2 CB 367.
7. IRC Sec. 1044.

is $500,000.[1] (The limits are $25,000 and $250,000, respectively, for married taxpayers filing separately.)

In the case of C corporations, the gain that may be deferred may not exceed the lesser of (a) $250,000 or (b) $1,000,000, reduced by any gain excluded in previous taxable years.[2]

To the extent that gain from the sale of publicly-traded securities exceeds the cost of the SSBIC common stock or partnership interest subsequently purchased, such gain will be taxed in the year of sale. Any gain that is characterized as ordinary income is not eligible for rollover treatment. In addition, gain previously rolled over under this provision may not be rolled over again.[3]

Basis in the SSBIC common stock or partnership interest is generally reduced by the amount of gain that is rolled over. Despite this, the basis of any SSBIC stock is not reduced for purposes of calculating the gain eligible for the 50 percent exclusion for qualified small business stock (see Q 8623).[4]

A "specialized small business investment company" is defined as any partnership or corporation that is licensed by the Small Business Administration under Section 301(d) of the Small Business Investment Act of 1958, as in effect on May 13, 1993.[5]

Estates, trusts, partnerships, and S corporations are not eligible to take advantage of this rollover provision.[6]

1. IRC Sec. 1044(b)(1).
2. IRC Sec. 1044(b)(2).
3. IRC Sec. 1044(a).
4. IRC Sec. 1044(d).
5. IRC Sec. 1044(c)(3).
6. IRC Sec. 1044(c)(4).