**8587. 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]](#footnote-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]](#footnote-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]](#footnote-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:

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.[[4]](#footnote-4)

*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.[[5]](#footnote-5)

1. . Treas. Reg. §1.121-1(e)(1), IRC Sec. 280A(f)(1)(A). [↑](#footnote-ref-1)
2. . Treas. Reg. §1.121-1(e)(1). [↑](#footnote-ref-2)
3. . Treas. Reg. §1.121-1(e)(3). [↑](#footnote-ref-3)
4. . Treas. Reg. §1.121-1(e)(1). [↑](#footnote-ref-4)
5. . Treas. Reg. §1.121-1(e)(4), Ex.6. [↑](#footnote-ref-5)