A Tax-Rule Change For 'Like-Kind' Trades

By Robert Irwin
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Question: I recently used a 1031 exchange to trade my investment property for a home into which I then moved to avoid paying capital-gains tax on the sale of the investment property. My plan is to live in this home for the two years required before I can sell and claim the $500,000 exclusion available to homeowners, thereby avoiding the capital-gains tax again. However, my accountant now tells me that I can no longer do this. Is he right?

-- Janice, Seattle

Janice: Listen to your accountant. In the past doing a "like-kind" trade -- a real-estate transaction in which a seller exchanges a property for a like-kind property of equal or greater value -- for a home and then living in it for the required two out of the previous five years to qualify for the up to $500,000 exclusion (for a married couple filing jointly) was a way of avoiding the payment of capital-gains tax. What you were essentially doing was converting an investment property to a principal residence and getting tax benefits.

However, the American Jobs Creation Act of 2004 changed that. Now, if you've done a Section 1031 like-kind exchange, you are denied the exclusion if you sell the home within five years of the exchange. You no longer can convert from investment to principal residence and then quickly (within two years) sell and claim the exclusion.

Remember, however, this applies only to property that was converted after a like-kind exchange. It does not apply to someone who simply buys and lives in a principal residence for at least two out of the five years prior to selling and wants to claim the up to $500,000 capital-gains exclusion for a married couple filing jointly.

The new law regarding capital-gains exclusions and like-kind exchanges applies to sales that take place after Oct. 22, 2004.

On the bright side, you have a home to live in for five years, which will likely appreciate. And, you might still be able to convert it back to an investment property by moving out, renting it and then doing another like-kind exchange and deferring your taxes again. Check with that good accountant when you're ready to sell the property to be certain of the latest tax laws.

The Internal Revenue Service has more info below.
From: http://www.irs.gov/newsroom/article/0,,id=130215,00.html

Recent Changes May Affect Your 2004 Taxes

Sale of Personal Residence Acquired in a Like-kind Exchange — Taxpayers who convert rental property to a principal residence should know that a tax law change may limit their ability to exclude gain on the sale of that residence if they obtained the property through a like-kind exchange. Generally, a taxpayer can exclude up to $250,000 of gain on the sale of a home, provided the individual has owned and used it as a principal residence for two out of the five years before the sale. The exclusion is $500,000 for a married couple if both meet the use test. The American Jobs Creation Act of 2004 does not allow any exclusion if the taxpayer sells the home within five years of acquiring the property through a like-kind exchange. The new law applies to sales after October 22, 2004.