

**Rev. Proc. 2005-14, 2005-7 IRB, 01/27/2005, IRC  
Sec(s). 121**

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**Exclusion of gain from sale of principal residence—single  
exchange of like-kind property.**

**Headnote:**

IRS offered guidance to taxpayers who exchanges single property that meets requirements for gain exclusion under [Code Sec. 121](#); and non-recognition of gain on like-kind exchange under [Code Sec. 1031](#); . Specific computation directions were provided: [Code Sec. 121](#); must be applied before [Code Sec. 1031](#); , followed by application of [Code Sec. 1031](#); to gain attributable to depreciation, with boot to be taken into account only to extent boot exceeds gain excluded under [Code Sec. 121](#); with respect to relinquished business property. Guidance was also provided computing basis, and hypothetical illustrations were given.

*Reference(s):* ¶ 1215.01(20); [Code Sec. 121](#); [Code Sec. 1031](#);

**Full Text:**

**1. Purpose**

This revenue procedure provides guidance on the application of §§ 121 and 1031 of the Internal Revenue Code to a single exchange of property.

**2. Background**

.01 Section 121(a) provides that a taxpayer may exclude gain realized on the sale or exchange of property if the property was owned and used as the taxpayer's principal residence for at least 2 years during the 5-year period ending on the date of the sale or exchange. Section 121(b) provides generally that the amount of the exclusion is limited to \$250,000 (\$500,000 for certain joint returns). Under § 121(d)(6), any gain attributable to depreciation adjustments (as defined in § 1250(b)(3)) for periods after May 6, 1997, is not eligible for the exclusion. This limitation applies only to depreciation allocable to the portion of the property to which the § 121 exclusion applies. See § 121-1(d)(1).

.02 Section 121(d), as amended by § 840 of the American Jobs Creation Act of 2004, Pub. L. 108-357, provides that, if a taxpayer acquired property in an exchange to which § 1031 applied, the § 121 exclusion will not apply if the sale or exchange of the property occurs during the 5-year period beginning on the date of the acquisition of the property. This provision is effective for sales or exchanges after October 22, 2004.

.03 Under § 1.121-1(e) of the Income Tax Regulations, a taxpayer who uses a portion of a property for residential purposes and a portion of the property for business purposes is treated as using the entire property as the taxpayer's principal residence for purposes of satisfying the 2-year use requirement if the residential and business portions of the property are within the same dwelling unit. The term "dwelling unit" has the same meaning as in § 280A(f)(1), but does not include appurtenant structures or other property. If, however, the business portion of the property is separate from the dwelling unit used for residential purposes, the gain allocable to the business portion of the property is not excludable unless the taxpayer has also met the 2-year use requirement for the business portion of the property.

.04 Section 1.121-1(e)(3) provides that, for purposes of determining the amount of gain allocable to the residential and business portions of the property, the taxpayer must allocate the basis and the amount realized using the same method of allocation the taxpayer used to determine depreciation adjustments (as defined in § 1250(b)(3)). Allocation based on the square footage of the residential and business portions of the property is an appropriate method of allocating the basis and the amount realized. Poague v. United States, 66 A.F.T.R.2d (RIA) 5825 (E.D. Va. 1990), aff'd, 947 F.2d 942 (4 Cir. 1991).

.05 Section 1031(a) provides that no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment (relinquished property) if the property is exchanged solely for property of like kind (replacement property) that is to be held either for productive use in a trade or business or for investment. Under § 1031(b), if a taxpayer also receives cash or property that is not like-kind property (boot) in an exchange that otherwise qualifies under § 1031(a), the taxpayer must recognize gain to the extent of the boot. Section 1031 does not apply to property that is used solely as a personal residence.

.06 Section 1012 provides that the basis of property is its cost. The basis of property acquired in an exchange is its fair market value, unless otherwise provided in the Code or regulations (for example, § 1031(d)). See Philadelphia Park Amusement Co. v. United States, 126 F. Supp. 184 [46 AFTR 1293] (Ct. Cl. 1954).

.07 Under § 1031(d), the basis of the replacement property is the same as the basis of the relinquished property, decreased by the amount of cash received and increased by the amount of gain recognized by the taxpayer in the exchange.

.08 Neither § 121 nor § 1031 addresses the application of both provisions to a single exchange of property. Section 121(d)(5)(B), however, provides rules for applying § 121 and another nonrecognition provision, § 1033, to a single replacement of property. Under § 1033, in general, gain is recognized only to the extent the amount realized from a compulsory or involuntary conversion of property exceeds the cost of qualifying replacement property, and the basis of the replacement property is its cost reduced by the amount of the gain not recognized.

.09 Section 121(d)(5)(B) provides that, in applying § 1033, the amount realized from the sale or exchange of property is treated as the amount determined without regard to § 121, reduced by the amount of gain excluded under § 121. Under § 121(d)(5)(B), the amount realized from an exchange of a taxpayer's principal residence for purposes of applying § 1033 is the fair market value of the relinquished property reduced by the amount of the gain excluded from gross income under § 121. Thus, Congress concluded that for exchanges meeting the requirements of both § 121 and, § 1033, (1) the § 121 exclusion should be applied to gain from the exchange before the application of, § 1033,

(2) for purposes of determining gain that may be deferred under § 1033, the § 121 exclusion should be applied first against amounts received by the taxpayer that are not reinvested in the replacement property (amounts equivalent to boot that would result in gain recognition absent the application of § 121), and (3) the gain excluded under § 121 should be added in the calculation of the taxpayer's basis in the replacement property. See S. Rep. No. 830, 88 Cong., 2d Sess. 52-53, 1964-1 C.B. (Part 2) 505, 556-7 ("the basis of the taxpayer in the newly acquired residence will be his basis for the old residence increased by any exclusion of gain obtained by him under the provision which is reinvested in the new residence"); H.R. Rep. No. 749, 88 Cong., 1 Sess. 47, 1964-1 C.B. (Part 2) 125, 171.

### 3. Scope

This revenue procedure applies to taxpayers who exchange property that satisfies the requirements for both the exclusion of gain from the exchange of a principal residence under § 121 and the nonrecognition of gain on the exchange of like-kind properties under § 1031. Thus, this revenue procedure applies only to taxpayers who satisfy the held for productive use in a trade or business or for investment requirement of § 1031(a)(1) with respect to the relinquished business property and the replacement business property (as defined below).

### 4. Application

.01 In general. Taxpayers within the scope of this revenue procedure may apply both the exclusion of gain from the exchange of a principal residence under § 121 and the nonrecognition of gain from the exchange of like-kind properties under § 1031 to an exchange of property by applying the procedures set forth in this section 4.

.02 Computation of gain.

(1) Application of § 121 before § 1031. Section 121 must be applied to gain realized before applying § 1031.

(2) Application of § 1031 to gain attributable to depreciation. Under § 121(d)(6), the § 121 exclusion does not apply to gain attributable to depreciation deductions for periods after May 6, 1997, claimed with respect to the business or investment portion of a residence. However, § 1031 may apply to such gain.

(3) Treatment of boot. In applying § 1031, cash or other non-like kind property (boot) received in exchange for property used in the taxpayer's trade or business or held for investment (the relinquished business property), is taken into account only to the extent the boot exceeds the gain excluded under § 121 with respect to the relinquished business property.

.03 Computation of basis. In determining the basis of the property received in the exchange to be used in the taxpayer's trade or business or held for investment (the replacement business property), any gain excluded under § 121 is treated as gain recognized by the taxpayer. Thus, under § 1031(d), the basis of the replacement business property is increased by any gain attributable to the relinquished business property that is excluded under § 121.

### 5. Examples

In each example below, the taxpayer is an unmarried individual and the property or a portion of the property has been used in the taxpayer's trade or business or held for investment within the meaning of § 1031(a) as well as used as a principal residence as required under § 121.

Example 1.

(i) Taxpayer A buys a house for \$210,000 that A uses as A's principal residence from 2000 to 2004. From 2004 until 2006, A rents the house to tenants and claims depreciation deductions of \$20,000. In 2006, A exchanges the house for \$10,000 of cash and a townhouse with a fair market value of \$460,000 that A intends to rent to tenants. A realizes gain of \$280,000 on the exchange.

(ii) A's exchange of a principal residence that A rents for less than 3 years for a townhouse intended for rental and cash satisfies the requirements of both §§ 121 and 1031. Section 121 does not require the property to be the taxpayer's principal residence on the sale or exchange date. Because A owns and uses the house as A's principal residence for at least 2 years during the 5-year period prior to the exchange, A may exclude gain under § 121. Because the house is investment property at the time of the exchange, A may defer gain under § 1031.

(iii) Under section 4.02(1) of this revenue procedure, A applies § 121 to exclude \$250,000 of the \$280,000 gain before applying the nonrecognition rules of § 1031. A may defer the remaining gain of \$30,000, including the \$20,000 gain attributable to depreciation, under § 1031. See section 4.02(2) of this revenue procedure. Although A receives \$10,000 of cash (boot) in the exchange, A is not required to recognize gain because the boot is taken into account for purposes of § 1031(b) only to the extent the boot exceeds the amount of excluded gain. See section 4.02(3) of this revenue procedure.

These results are illustrated as follows.

Amount realized .....	\$470,000
Less: Adjusted basis .....	\$190,000
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Realized gain .....	\$280,000
Less: Gain excluded under § 121 .....	\$250,000
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Gain to be deferred .....	\$ 30,000

(iv) A's basis in the replacement property is \$430,000, which is equal to the basis of the relinquished property at the time of the exchange (\$190,000) increased by the gain excluded under § 121 (\$250,000), and reduced by the cash A receives (\$10,000). See section 4.03 of this revenue procedure.

Example 2.

(i) Taxpayer B buys a property for \$210,000. The property consists of two separate dwelling units (within the meaning of § 1.121-1(e)(2)), a house and a guesthouse. From 2001 until 2006, B uses the house as B's principal residence and uses the guesthouse as an office in B's trade or business. Based on the square footage of the respective parts of the property, B allocates 2/3 of the basis of the property to the house and 1/3 to the guesthouse. In 2006, B exchanges the entire property for a residence and a separate property that B intends to use as an office. The total fair market value of B's replacement properties is \$360,000. The fair market value of the replacement residence is \$240,000 and the fair market value of the replacement business property is \$120,000, which is equal to the fair market value of the relinquished business property. From 2001 to 2006, B claims depreciation deductions of \$30,000 for the business use. B realizes gain of \$180,000 on the exchange.

(ii) Under § 121, B may exclude gain of \$100,000 allocable to the residential portion of the house (2/3 of \$360,000 amount realized, or \$240,000, minus 2/3 of \$210,000 basis, or \$140,000) because B meets the ownership and use requirements for that portion of the property. Because the guesthouse is business property separate from the dwelling unit and B has not met the use requirements for the guesthouse, B may not exclude the gain allocable to the guesthouse under § 1.121-1(e). However, because the fair market value of the replacement business property is equal to the fair market value of the relinquished business property and B receives no boot, B may defer the remaining gain of \$80,000 (1/3 of \$360,000 amount realized, or \$120,000, minus \$40,000 adjusted basis, which is 1/3 of \$210,000 basis, or \$70,000, adjusted by \$30,000 depreciation) under § 1031.

These results are illustrated as follows:

	Total	2/3 residential	1/3
business	property	property	property
Amount realized	\$360,000	\$240,000	\$120,000
Basis	\$210,000	\$140,000	\$ 70,000
Depreciation adjustment	\$ 30,000		\$ 30,000
Adjusted basis	\$180,000	\$140,000	\$ 40,000
Realized gain	\$180,000	\$100,000	\$ 80,000
Gain excluded under § 121	\$100,000	\$100,000	
Gain deferred under § 1031	\$ 80,000		\$ 80,000

(iii) Because no portion of the gain attributable to the relinquished business property is excluded under § 121 and B receives no boot and recognizes no gain or loss in the exchange, B's basis in the replacement business property is equal to B's basis in the relinquished business property at the time of the exchange (\$40,000). B's basis in the replacement residential property is the fair market value of the replacement residential property at the time of the exchange (\$240,000).

Example 3. (i) Taxpayer C buys a property for \$210,000. The property consists of a house that constitutes a single dwelling unit under § 1.121-1(e)(2). From 2001 until 2006, C uses 2/3 of the house (by square footage) as C's principal residence and uses 1/3 of the house as an office in C's trade or business. In 2006, C exchanges the entire property for a residence and a separate property that C intends to use as an office in C's trade or business. The total fair market value of C's replacement properties is \$360,000. The fair market value of the replacement residence is \$240,000 and the fair market value of the replacement business property is \$120,000, which is equal to the fair market value of the business portion of the relinquished property. From 2001 to 2006, C claims depreciation deductions of \$30,000 for the business use. C realizes gain of \$180,000 on the exchange.

(ii) Under § 121, C may exclude the gain of \$100,000 allocable to the residential portion of the house (2/3 of \$360,000 amount realized, or \$240,000, minus 2/3 of \$210,000 basis, or \$140,000) because C meets the ownership and use requirements for that portion of the property.

(iii) The remaining gain of \$80,000 (1/3 of \$360,000 amount realized, or \$120,000, minus \$40,000 adjusted basis, which is 1/3 of \$210,000 basis, or \$70,000, adjusted by \$30,000 depreciation) is allocable to the business portion of the house (the office). Under section 4.02(1) of this revenue procedure, C applies § 121 before applying the nonrecognition rules of § 1031. Under § 1.121-1(e), C may exclude \$50,000 of the gain allocable to the office because the office and residence are part of a single dwelling unit. C may not exclude that portion of the gain (\$30,000) attributable to depreciation deductions, but may defer the remaining gain of \$30,000 under § 1031. These results are illustrated as follows:

	Total property	2/3 residential property	1/3 property
business			
Amount realized	\$360,000	\$240,000	\$120,000
Basis	\$210,000	\$140,000	\$ 70,000
Depreciation adjustment	\$ 30,000		\$ 30,000
Adjusted basis	\$180,000	\$140,000	\$ 40,000

Realized gain	\$180,000	\$100,000	\$ 80,000
Gain excluded under § 121	\$150,000	\$100,000	\$ 50,000
Gain deferred under § 1031	\$ 30,000		\$ 30,000

(iv) C's basis in the replacement residential property is the fair market value of the replacement residential property at the time of the exchange (\$240,000). C's basis in the replacement business property is \$90,000, which is equal to C's basis in the relinquished business property at the time of the exchange (\$40,000), increased by the gain excluded under § 121 attributable to the relinquished business property (\$50,000). See section 4.03 of this revenue procedure.

Example 4.

(i) The facts are the same as in Example 3 except that C also receives \$10,000 of cash in the exchange and the fair market value of the replacement business property is \$110,000, which is \$10,000 less than the fair market value of the business portion of the relinquished property (\$120,000).

(ii) Under § 121, C may exclude the gain of \$100,000 allocable to the residential portion of the house (2/3 of \$360,000 amount realized, or \$240,000, minus 2/3 of \$210,000 basis, or \$140,000).

(iii) The remaining gain of \$80,000 (1/3 of \$360,000 amount realized, or \$120,000, minus \$40,000 adjusted basis) is allocable to the business portion of the house. Under section 4.02(1) of this revenue procedure, C applies § 121 to exclude gain before applying the nonrecognition rules of § 1031. Under § 1.121-1(e), C may exclude \$50,000 of the gain allocable to the business portion of the house but may not exclude the \$30,000 of gain attributable to depreciation deductions. Under section 4.02(2) of this revenue procedure, C may defer the \$30,000 of gain under § 1031. Although C receives \$10,000 of cash (boot) in the exchange, C is not required to recognize gain because the boot is taken into account for purposes of § 1031(b) only to the extent the boot exceeds the amount of excluded gain attributable to the relinquished business property. See 4.02(3) of this revenue procedure.

These results are illustrated as follows:

	Total property	2/3 residential property	1/3 business property
Amount realized 10,000	\$360,000	\$240,000	\$110,000 +
Basis	\$210,000	\$140,000	\$ 70,000

Depreciation adjustment	\$ 30,000		\$ 30,000
Adjusted basis	\$180,000	\$140,000	\$ 40,000
Realized gain	\$180,000	\$100,000	\$ 80,000
Gain excluded under § 121	\$150,000	\$100,000	\$ 50,000
Gain deferred under § 1031	\$ 30,000		\$ 30,000

(iv) C's basis in the replacement residential property is the fair market value of the replacement residential property at the time of the exchange (\$240,000). C's basis in the replacement business property is \$80,000, which is equal to C's basis in the relinquished business property (\$40,000), increased by the gain excluded under § 121 (\$50,000), and reduced by the cash (\$10,000) received. See section 4.03 of this revenue procedure.

Example 5.

- (i) The facts are the same as in Example 3 except that the total fair market value of the replacement properties is \$540,000. The fair market value of the replacement residence is \$360,000, the fair market value of the replacement business property is \$180,000, and C realizes gain of \$360,000 on the exchange.
- (ii) Under § 121, C may exclude the gain of \$220,000 allocable to the residential portion of the house (2/3 of \$540,000 amount realized, or \$360,000, minus 2/3 of \$210,000 basis, or \$140,000).
- (iii) The remaining gain of \$140,000 (1/3 of \$540,000 amount realized, or \$180,000, minus \$40,000 adjusted basis) is allocable to the business portion of the house. Under section 4.02(1) of this revenue procedure, C excludes the gain before applying the nonrecognition rules of § 1031. Under § 1.121-1(e), C may exclude \$30,000 of the gain allocable to the business portion, at which point C will have excluded the maximum limitation amount of \$250,000. C may defer the remaining gain of \$110,000 (\$140,000 realized gain minus the \$30,000 gain excluded under § 121), including the \$30,000 gain attributable to depreciation, under § 1031.

These results are illustrated as follows:

	Total property	2/3 residential property	1/3 property
Amount realized	\$540,000	\$360,000	\$180,000

Basis	\$210,000	\$140,000	\$ 70,000
Depreciation adjustment	\$ 30,000		\$ 30,000
Adjusted basis	\$180,000	\$140,000	\$ 40,000
Realized gain	\$360,000	\$220,000	\$140,000
Gain excluded under § 121	\$250,000	\$220,000	\$ 30,000
Gain deferred under § 1031	\$110,000		\$110,000

(iv) C's basis in the replacement residential property is the fair market value of the replacement residential property at the time of the exchange (\$360,000). C's basis in the replacement business property is \$70,000, which is equal to C's basis in the relinquished business property (\$40,000), increased by the amount of the gain excluded under § 121 (\$30,000). See section 4.03 of this revenue procedure.

Example 6.

- (i) The facts are the same as in Example 3 except that the total fair market value of the replacement properties is \$750,000. The fair market value of the replacement residence is \$500,000, the fair market value of the replacement business property is \$250,000, and C realizes gain of \$570,000 on the exchange.
- (ii) The gain allocable to the residential portion is \$360,000 (2/3 of \$750,000 amount realized, or \$500,000, minus 2/3 of \$210,000 basis, or \$140,000). C may exclude gain of \$250,000 from gross income under § 121. C must include in income the gain of \$110,000 allocable to the residential portion that exceeds the § 121(b) exclusion limitation amount.
- (iii) The remaining gain of \$210,000 (1/3 of \$750,000 amount realized, or \$250,000, minus \$40,000 adjusted basis) is allocable to the business portion of the house. C may defer the \$210,000 of gain, including the \$30,000 gain attributable to depreciation, under § 1031.

These results are illustrated as follows:

	Total property	2/3 residential property	1/3 property
Amount realized	\$750,000	\$500,000	\$250,000

Basis	\$210,000	\$140,000	\$ 70,000
Depreciation adjustment	\$ 30,000		\$ 30,000
Adjusted basis	\$180,000	\$140,000	\$ 40,000
Realized gain	\$570,000	\$360,000	\$210,000
Gain excluded under § 121	\$250,000	\$250,000	
Gain deferred under § 1031	\$210,000		\$210,000
Gain recognized	\$110,000	\$110,000	

(iv) C's basis in the replacement residential property is the fair market value of the replacement residential property at the time of the exchange (\$500,000). C's basis in the replacement business property is \$40,000, which is equal to C's basis in the relinquished business property at the time of the exchange.

## 6. Effective Date

This revenue procedure is effective January 27, 2005. However, taxpayers may apply this revenue procedure in taxable years for which the period of limitation on refund or credit under § 6511 has not expired.

## Drafting Information

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