

Examples of How IRC §121 and §1031 Combine for Sales of Combination and Dual-Use Residential/Business Use Properties

Rev. Proc. 2005-14

Below are the full-text examples contained in the Rev Proc. 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
Realized gain	\$280,000
Less: Gain excluded under § 121	\$250,000
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 property	2/3 residential property	1/3 business 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 business 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	\$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	\$360,000	\$240,000	\$110,000 + 10,000
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 business 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 business 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.