

**REVENUE PROCEDURE 2005-14, EFFECTIVE JANUARY 27, 2005:  
GUIDANCE ON THE APPLICATION OF SECTIONS 121 AND 1031 TO  
A SINGLE EXCHANGE OF PROPERTY.**

**Rev. Proc. 2005-14** applies to Taxpayers who exchange property that satisfies the requirements for both the exclusion of gain from the exchange of a principal residence under Section 121 and the nonrecognition of gain on the exchange of like-kind property under Section 1031. Thus, Rev. Proc. 2005-14 applies only to Taxpayers who satisfy (i) the two-year principal residence test of Section 121, and (ii) the held for productive use in a trade or business or for investment requirement of Section 1031(a)(1) with respect to the relinquished property and the replacement property.

**Computing Gain:** Section 121 is applied to gain realized before applying Section 1031.

**Gain from Depreciation:** Under Section 1031(d)(6), the exclusion under Section 121 does not apply to gain attributed to depreciation deductions claimed for the business or investment portion of a residence (for periods after May 6, 1997). Section 1031 may apply to such gain.

**Treatment of Boot:** In applying Section 1031, cash or other non-like kind property received (boot) is taken into account to the extent the boot received exceeds the gain excluded under the Section 121 portion of the property.

**Calculating Basis:** In determining the Taxpayer's basis in it's' investment portion of the Replacement Property, any gain excluded under Section 121 is treated as gain recognized by the Taxpayer. Under Section 1031(d) then the basis of the replacement property is increased by any gain attributable to the investment portion of the relinquished property that is excluded under Section 121.

**Example:** Taxpayer purchases a home for \$200,000 that it occupies as its principal residence from 2000 to 2004. In 2004, Taxpayer rents the house to tenants and claims depreciation deductions totaling \$20,000. In 2006 Taxpayer exchanges the house in a Section 1031 exchange and receives \$10,000 in cash boot and Replacement Property townhouse worth \$450,000. Taxpayer has \$280,000 in realized gain with the following result:

	Relinquished Property		Replacement Property
Original Cost	\$200,000	FMV of Property Received	\$450,000
Less: Depreciation	(\$20,000)	Cash Boot Received	\$10,000
Adjusted Cost Basis	\$180,000	Total Value	\$460,000
		Less: Adjusted Cost Basis of Relinquished Property	(\$180,000)
		<b>Realized Gain</b>	<b>\$280,000</b>

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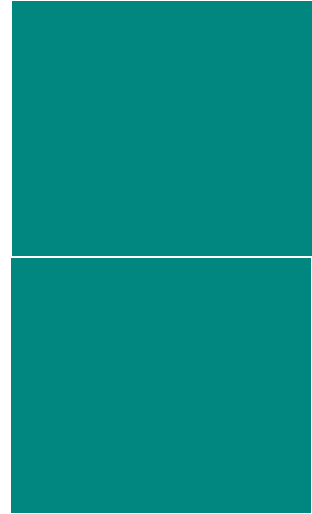
Section 121 does not require that the property be the Taxpayer's principal residence at the time of the exchange – just that Taxpayer had occupied the residence as its principal residence for a period aggregating two of the last five years. The property is eligible for exclusion of gain under Section 121.

Additionally, because the house was held for investment “at the time of the exchange” [note that it was held for two years as investment property, though this does not appear to be a requirement from the language] the Taxpayer may also defer gain under Section 1031.

Applying the gain exclusion under Section 121 first, Taxpayer may exclude \$250,000 of the \$280,000 gain. The remaining \$30,000 of gain is deferred under Section 1031 (including the \$20,000 attributed to depreciation deductions).

And the \$10,000 cash “boot” received by the Taxpayer is also tax-deferred. The cash boot received is recognized only to the extent the boot exceeds the amount of the excluded gain (in this example, \$250,000).

The Rev. Proc. also provides an example where 2/3rds of a single dwelling unit is residence and 1/3rd is business/investment property. Taxpayer exchanges the property for a new residence and a separate investment property. The exchange is eligible for tax deferral under Section 1031.



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