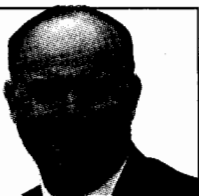


Tom Kelly



New rules govern exchange properties

Deep in the folds of the recently signed American Jobs Creation Act of 2004 — the same law that will allow Washington residents to deduct state sales taxes from their income tax returns in 2004 and 2005 — is a subtle yet important change for homeowners who have acquired their principal residence via a tax-deferred exchange.

The new law includes a stipulation that the exchange property must be held for five years in order to qualify for the \$500,000 (\$250,000 for a single person) principal residence tax-free exemption.

"It may be disguised as a safe harbor for people who buy an investment property, rent it out for three years, then live in it for two years before selling it," said Kelly Yates, attorney and exchange specialist in Seattle-based Exchange Facilitator Corp. "Yet it appears they are trying to clamp down on people who simply buy investment properties and then move into them."

In order to qualify for the exclusion, homeowners must have owned and used the property as a principal residence for two out of the five years prior to the date of sale. Second, the owner must not have used the exclusion in the two-year period prior to the sale. So the only limit on the number of times a taxpayer can claim this exclusion is once in any two-year period.

The committee that drafted the section of the new law did not believe the principal residence exclusion "was appropriate for properties that were recently acquired in like-kind exchanges." Under the exchange rules, commonly known as 1031 exchanges or Starker exchanges, a taxpayer who exchanges property that was held for productive use or investment for "like kind" property may acquire the replacement property on a tax-free basis. Because the replacement property generally has a low carry-over tax basis, the taxpayer will have taxable gain upon the sale of the replacement property.

However, when the homeowner converts the replacement property into a principal residence, the taxpayer may shelter some or all of this gain from income taxes. The committee believed this proposal "balances the concerns associated with these provisions to reduce this tax shelter concern without unduly limiting the exclusion on sales or exchanges of principal residences."

While the new rule is important — especially to folks looking to move into a rental property they own — it is not critical. That's because an investment property typically needs to be rented (used as an investment) after an exchange to show the exchange was clearly an investment-for-investment transaction. Accountants say the exchanged property should be held for at least two tax years as an investment property before an owner considers converting it to a primary residence. In addition, once the homeowners move into the new primary residence, they must stay at least two years before qualifying for the \$500,000 exclusion.

When you add the suggested two years as investment property with the two years required under the residency guideline, that's four years needed for the new mandatory five-year rule.

For those who leave their home because of a disability, a special rule makes it easier to meet the two-year requirement

See KELLY, Page F4

Kelly

From Page F1

— especially if you were hospitalized or had to spend a significant period in a similar facility. In such cases, if you owned and used the home as a principal residence for at least one of the five years preceding the sale, you are treated as having used it as your principal residence while you are in a facility that is licensed to care for people in your condition. This rule, especially helpful for some seniors, enables the family to sell the home to raise cash for the expenses without incurring a large tax bite.

Yates and other tax attorneys caution that all exchanges must meet the "facts and circumstances" test regardless of how much time has passed before converting an investment property to a personal residence. If it's clear at the time of the exchange that a taxpayer intended to use the exchange property as a primary residence, the exchange can be attacked, Yates said.

A tax-deferred exchange proceeds just as a sale for you, your real estate agent and parties associated with the deal. In fact, Richard Morse, an attorney at Washington Exchange Services, refers to exchanges as "legally sanctioned fiction."

Section 1031 of the Internal Revenue Service code specifically requires that an exchange take place. That means that one property must be exchanged for another property, rather than sold for cash. The exchange is what distinguishes a Section 1031 tax deferred transaction from a sale and purchase. The exchange is created by using an intermediary (or exchange facilitator) and the required exchange documentation.

If you've traded for a golf course getaway condo and now think you would like to live there, make sure you own it for five years before attempting to pocket a principal residence exemption.

However, once you get there, do you think you'll ever want to sell?

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