

INTERNAL REVENUE SERVICE

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Dear _____ :

This letter responds to your inquiry to Senator Barbara Mikulski about the recently enacted tax law changes affecting sections 1031 and 121 of the Internal Revenue Code. Senator Mikulski asked us to respond to you directly.

You asked for the effective date of the tax law changes affecting investment property acquired in a like-kind exchange and converted into a principal residence and whether a "grandfather" clause applies to these provisions. In addition, you asked whether an owner of investment property can satisfy the two-year ownership and use requirements during the five-year period beginning on the date the owner acquired the property.

The law provides for the tax-free exchange of like-kind property. Specifically, a taxpayer can not realize a gain or loss on the exchange of property held for productive use in a trade or business or for investment if he or she exchanges the property solely for property of like-kind to be held either for productive use in a trade or business or for investment [Section 1031(a) of the Code].

A taxpayer can exclude up to \$250,000 of gain (or \$500,000 for certain joint returns) from the sale or exchange of property if the taxpayer owned and used the property as his or her principal residence for at least two years during the five-year period before the sale or exchange [Section 121(a) and (b) of the Code]. However, any gain attributable to depreciation adjustments for periods after May 6, 1997, is not eligible for this exclusion [Section 121(d)(6) of the Code].

The American Jobs Creation Act of 2004 added section 121(d)(10) to the Code. This section provides that if a taxpayer acquired property in a like-kind exchange to which section 1031 applied, the taxpayer can not exclude gain from the sale or exchange of the property under section 121 if the sale or exchange occurs during the five-year period beginning on the date the taxpayer acquired the property. Although the statute does not restrict a taxpayer from satisfying the two-year ownership and use requirements during the five-year period following the acquisition date, a taxpayer

