Reg. Section 1.121-1(d)

Exclusion of gain from sale or exchange of a principal residence.

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(d) Depreciation taken after May 6, 1997 –

(1) In general. The section 121 exclusion does not apply to so much of the gain from the sale or exchange of property as does not exceed the portion of the depreciation adjustments (as defined in section 1250(b)(3)) attributable to the property for periods after May 6, 1997. Depreciation adjustments allocable to any portion of the property to which the section 121 exclusion does not apply under paragraph (e) of this section are not taken into account for this purpose.

(2) Example. The provisions of this paragraph (d) are illustrated by the following example:

Example. On July 1, 1999, Taxpayer A moves into a house that he owns and had rented to tenants since July 1, 1997. A took depreciation deductions totaling $ 14,000 for the period that he rented the property. After using the residence as his principal residence for 2 full years, A sells the property on August 1, 2001. A's gain realized from the sale is $ 40,000. A has no other section 1231 or capital gains or losses for 2001. Only $ 26,000 ($ 40,000 gain realized -- $ 14,000 depreciation deductions) may be excluded under section 121. Under section 121(d)(6) and paragraph (d)(1) of this section, A must recognize $ 14,000 of the gain as unrecaptured section 1250 gain within the meaning of section 1(h).

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