1031 Exchange & Primary Residence

IRC Section 1031 and 121

1031 Knowledge

The tax code provides a number of provisions that provide benefits to taxpayers who own real property. IRC Section 1031 allows for tax deferral on the sale of a property used in a trade or business or held for investment when exchanged for like-kind replacement property to be used in a trade or business or held for investment. Section 1031 only provides for tax deferral as the original basis is carried over into the replacement property and capital gain taxes are owed when the replacement property is later sold and cash is received. Section 121 allows for tax exclusion on the sale of a principal residence when the taxpayer lives in the property as their residence for two out of the past five years. Taxpayers meeting these requirements can exclude up to $250,000 of gain if filing as a single taxpayer and $500,000 of gain if married and filing jointly. Section 121 provides for tax exclusion up to these $250,000/$500,000 threshold amounts while §1031 provides only tax deferral but with no limit on the amount of deferral.

There are numerous scenarios involving tax code §1031 and §121:

1. §1031 tax-deferred exchange (tax deferral on a property used in a business or held for investment);
2. §121 principal residence sale (tax exclusion when the taxpayer lives in the property as a residence for at least two out of the past five years);
3. Split treatment, part business/investment and part principal residence (a portion of the property treated as §1031 and a portion treated as §121);
4. Split treatment, part farm/ranch and part principal residence (a portion of the property treated as §1031 and a portion treated as §121);
5. Convert a rental property into a principal residence (§1031 property later converted into to §121 property); and,
6. Convert a principal residence into rental property (§121 property converted into §1031 property);
7. Allocations and Restrictions under the Housing Assistance Tax Act of 2008.

1. Highlights of §1031 Exchange Property (Taxpayer Uses Property in a Business or Property is Held for Investment)

- Tax deferral;
- The taxpayer must hold both the relinquished and replacement property for use in a business or the property must be held for investment called like-kind property);
- The taxpayer cannot receive the cash proceeds from the sale and must engage a qualified intermediary (QI) prior to closing to structure as a valid §1031 exchange;

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- There are strict rules for deferral including 45/180 day time deadlines in the delayed exchange format along with other requirements such as reinvesting the entire net equity and having the same or greater amount of debt to obtain full tax deferral.

2. Highlights of Section 121 Principal Residence Property (Taxpayer Lives in the Property)

- Tax exclusion;
- The taxpayer must use the property as a principal residence for two out of the last five years prior to the sale;
- The use as a principal residence does not need to be in concurrent months;
- Exclusion of $250,000 of gain for single filers and $500,000 of gain for married taxpayers filing jointly;
- The §121 exclusion is only available once every two years;
- Second homes and vacation homes do not qualify for §121 tax exclusion.

3. Split Treatment Transaction: Portion §121 (Residence) and a Portion §1031 (Used in a Business or Held for Investment)

- A split treatment transaction involves a property used partially as a principal residence and partially in a business or held for investment purposes;
- The taxpayer and their tax advisor must allocate the portion used as a principal residence for tax exclusion under §121 and the remaining portion qualifying for §1031 deferral;
- The taxpayer can receive the sale proceeds directly from the closing on the principal residence allocation of the transaction;
- The taxpayer must have a QI in place for the §1031 exchange portion of the transaction (i.e. the portion allocated to business or held for investment.) The QI will receive the portion of the sale proceeds for the business or investment portion and the QI will acquire like-kind replacement property pursuant to the §1031 exchange rules and requirements. The taxpayer must meet all other requirements necessary for a §1031 exchange.

An Example: The Sale of a Four-Unit Property (Fourplex)

The taxpayer owns a fourplex in which they rented three units for the past four years (§1031) and where they have also lived in the remaining unit as their principal residence (§121) for the past four years (meeting the requirement under §121 to have used as a principal residence for at least two of the past five years.) The property is sold to a buyer and the taxpayer receives the portion of the sale attributed to the principal residence portion (§121) and has a QI engaged to hold the net proceeds from the sale of the three rental units to proceed with a 1031 exchange into a like-kind replacement property.

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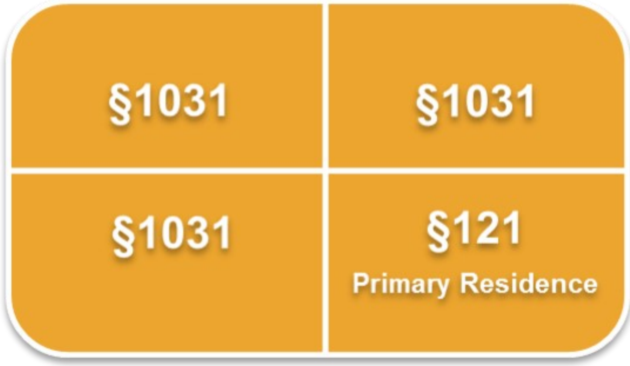
Sale of a Fourplex

- **3 Units rented**
- **1 Unit primary residence**
  - **§1031 - 3/4**
  - **§121 - 1/4**



4. Split Treatment Transaction: Portion §121 (Residence) and a Portion §1031 (Farm or Ranch)

- A split treatment transaction involves a property used partially as a principal residence and partially for a farm or ranch;
- The taxpayer and their tax advisor must allocate the portion used as a principal residence for tax exclusion under §121 and the remaining farm/ranch portion qualifying for §1031 deferral;
- The taxpayer can receive the sale proceeds directly from the closing on the principal residence allocation of the transaction;
- The taxpayer must have a QI in place for the §1031 exchange portion of the transaction (i.e. the portion allocated to business or held for investment.) The QI will receive the portion of the sale proceeds from the farm or ranch portion and the QI will acquire like-kind replacement property pursuant to the §1031 exchange rules and requirements. The taxpayer must meet all the other requirements necessary for a §1031 exchange.

An Example: The Sale of a 100-Acre Ranch with the Allocation of a Primary Residence on Five Acres

The taxpayer has owned a 100-acre working ranch for the past four years and has lived in the ranch house on the property. The minimum amount of acres for a primary residence the county allows is five acres. The property is sold to a

buyer and the taxpayer receives the portion of the sale attributed to the principal residence portion, principal residence and five acres of land (§121) and has a QI engaged to hold the net proceeds from the sale of the ranch/land portion, 95 acres, with a 1031 exchange into a like-kind replacement property.

5. Convert Rental Property into a Principal Residence (§1031 Converted to §121)

In this scenario, the taxpayer must hold the property acquired as replacement property in a §1031 exchange with the intent to initially hold for business or investment purposes. Ideally, the taxpayer should have facts/circumstances and documentation to support the intent to use in a business or hold for investment after the §1031 exchange. There is also a minimum five-year holding period post-exchange. The taxpayer must also use as a principal residence for at least two of the five years to be eligible for §121 tax exclusion. The §121 exclusion is reduced by a ratio of the time the property was used as a principal residence compared to the time the property was used in a business or investment. And, finally, any depreciation recapture taken during the time the property was used in a business or held for investment is excluded.

An Example: A taxpayer performs a §1031 exchange into a replacement property which they intend to initially hold for investment and the property is rented for three years. The taxpayer's intent changes in the future and they decide to move into the former rental property after three years of renting and live in the property for five more years as a principal residence. The total ownership is eight years (which is over the minimum five-year holding period when converting a rental property into a principal residence.) In this scenario, the taxpayer is eligible for 5/8ths of the §121 tax exclusion since they lived in the property only five of the past eight years and the depreciation recapture during the three-year rental time period is not eligible for tax exclusion.

6. Convert Principal Residence into a Rental Property (§121 Convert to §1031)

Revenue Procedure 2005-14 provides guidance for the concurrent application of §121 and §1031 if a taxpayer has converted a principal residence into a rental property. In this scenario, the taxpayer must meet the requirements of §121 and have lived in the property for two out of the past five years before the taxpayer converts the principal residence into a rental property. The taxpayer can exclude capital gain taxes up to the threshold amounts of §121 ($250,000 single; $500,000 married) – and perform a §1031 tax-deferred exchange into a replacement property under §1031 which is to be held for investment or used in a business. The taxpayer is able to take advantage of both tax exclusion pursuant to §121 and also tax deferral pursuant to §1031 on the remaining portion of the sale and above the §121 threshold exclusion amounts.

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7. Allocations and Restrictions Under the Housing Assistance Tax Act of 2008

The Housing Assistance Act of 2008 addressed many issues related to §121 exclusion of gain on the sale of a primary residence including the segregation of the time a residence is held into qualified and nonqualified holding periods. Section 121 tax exclusion must be allocated between the period of time the property was used as an investment property and the period of time the property was used as a principal residence. Section 121 exclusion of gain does not apply to any gain associated with a nonqualified holding period (when the property was not used as a principal residence.)

The classification of the holding period as either qualified or nonqualified is important. Under the Housing Assistance Act of 2008, any period that is not a qualified holding period is defined as a nonqualified holding period. A qualified holding period is defined as the following:

- Any period when the taxpayer used the property as his or her principal residence; or
- Any portion of the five-year period following the taxpayer's use of the property as a principal residence if the property is sold within that five-year period of time.

The qualified holding period includes the time the property is used as a principal residence by the taxpayer, the taxpayer's spouse, or the taxpayer's former spouse. (See: Sec. 121(b)(4)[5](C)(i))

In general, the allocation rules only apply to time periods prior to the conversion into a principal residence and not to time periods after the conversion out of a principal residence Accordingly, if a single taxpayer converts a principal residence into a rental property and never moves back in, and otherwise meets the two out of five year requirement under §121, the taxpayer is eligible for the full $250,000 exclusion when the rental property is sold. This rule applies to nonqualified used periods within the 5-year lookback period of §121 after the last date the property was used as a principal residence. Therefore, if a taxpayer used the property as a principal residence in year one and year two, then rented the property for years three and four, and then used the property as a principal residence in year five, the allocation rules would apply and only three-fifths (3 out of 5 years) of the gain would be eligible for the tax exclusion under §121.

Every taxpayer is urged to seek the advice of a tax advisor to review their specific situation and application of tax rules.

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