IRC §121 & §1031

1031 Knowledge

As many tax and legal advisors know, a taxpayer may exclude from income a portion of the gain resulting from a sale of the taxpayer's principal residence. Under Internal Revenue Code Section 121, a married couple is permitted to exclude $500,000 of gain, and a single taxpayer may exclude $250,000. To qualify for the home sale exclusion, the taxpayer must have owned the property and used the property as the taxpayer's principal residence for any two of the most recent five years (determined with reference to the sale of the principal residence). The exclusion may only be claimed once every two years.

Based upon the foregoing rule, many taxpayers have pursued a strategy that involves converting appreciated investment property into a principal residence, living there for two years and thereafter selling the property as a principal residence. In doing so, the taxpayer was able to eliminate capital gain on the sale of the appreciated property up to the amount of the permitted exclusion in as little as two years. Congress acted to restrict (but not eliminate) the ability of these taxpayers to eliminate deferred gains attributable to prior exchange transactions.

In 2004, Congress amended section 121 to provide that in cases where a taxpayer acquires investment property in a tax-deferred exchange under Code Section 1031, and thereafter converts the property into a principal residence, the exclusion from gain resulting from the sale of the taxpayer's principal residence will not apply if the sale occurs during the 5-year period commencing on the date the property was originally acquired. See Internal Revenue Code §121(d)(10). Absent the 5-year rule, a taxpayer could defer gain on business or investment property in a Code Section 1031 exchange, and, after converting the property received in the exchange to a principal residence, reduce or eliminate that gain by excluding it under the home sale exclusion. Thus, gain from business or investment property that was only meant to be *deferred* under Code Section 1031 would be permanently *excluded* under a provision that was meant to apply only to a taxpayer's principal residence.

The limitation under Section 121(d)(10) prevents a taxpayer from sheltering all or part of that deferred gain under the home sale exclusion unless they hold the property received in the exchange (that was converted to a principal residence) for at least five years. As long as the sale of the taxpayer's principal residence occurs *more* than five years after the date of the acquisition of the residence, however, the Section 121(d)(10) limitation does not apply and a portion of the gain (other than gain resulting from accumulated depreciation) may be excluded under Section 121 assuming that the sale otherwise satisfies the requirements for the home sale exclusion, such as the two-year use requirement.

Compliments of:

HQ 800.282.1031 | NY 866.394.1031

apiexchange.com | info@apiexchange.com

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1031 Knowledge

As previously mentioned, the amount that may be excluded under Section 121 is limited to $500,000 for married couples and $250,000 for single individuals. Given increases in the value of investment real estate, and with the five-year wait between the acquisition of property converted to a residence and its sale, many taxpayers are faced with gains far in excess of amounts that may be excluded under Section 121. Moreover, by converting the residence from an investment property to a principal residence, the taxpayer eliminates the potential to exchange the property under Section 1031, . . . or do they?

In Revenue Procedure 2005-14, the Internal Revenue Service explains how a taxpayer may treat property that would qualify for the Section 121 home sale exemption as partially investment property and partially principal residence. In other words, a sale of a residence may be given split treatment; a portion may be treated as held primarily for investment, (which portion would be eligible for exchange under Section 1031), and a portion that would be treated as the taxpayer's principal residence. A transaction may be treated as a split transaction under one of two scenarios. First, a taxpayer may have property that is treated as investment property as of the date of the sale, but had previously used it for a principal residence two or more years during the previous five years. Second, the property may consist of acreage that is not associated with the residence itself. In either case, the property qualifies as investment property in part, and as a principal residence in part.

In allocating between the portion of the property associated with the taxpayer's residence, the taxpayer should rely upon the advice of a competent tax advisor. In the event of an audit, the IRS may review the basis upon which the allocation is made to determine if the allocation is reasonable. By allocating, however, a taxpayer may be able to not only exclude gain under Section 121, but may also defer gain on the investment property by doing a 1031 exchange. For more information on the interaction between section 1031 and section 121, *see* [1031 Exchange and Primary Residence].

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