Legal 1031
Exchange Services, LLC
a Subsidiary of Truist Financial Corporation

BEST OF BOTH WORLDS IRC §121 and IRC §1031

A property owner selling a property that is held both as a primary residence and an investment property may qualify for tax benefits under both IRC §121 and IRC §1031. The issuance of Revenue Procedure 2005-14 provides taxpayers with clear guidance on the structuring and removed the uncertainty as to the qualifications of such transactions.

IRC §121 provides for an exclusion of the capital gain tax upon the sale of a principal residence in which the taxpayer lives in the property two out of the last five years (generally speaking). The maximum exclusion under §121 is $250,000 for those filing as single and $500,000 for those filing a joint return.

IRC §1031 allows property held for business or investment purposes to be exchanged for like-kind property while deferring most, if not all, of the capital gains related taxes upon the sale of the property.

In a dual-use property, whereby the property qualifies under IRC §121 and IRC §1031, the portion of the property where the owner lives as their primary residence may qualify for the primary residence exclusion under IRC §121. The portion of the property held for business or investment use may qualify for a tax deferral under IRC §1031.

A common example is when a taxpayer owns a four-family property. They live in one unit and rent out the other three units. In such situation, the taxpayer may qualify for the primary residence exemption on 25% of the property while also qualifying for the 1031 exchange on the 75% of the property representing the rental units. By utilizing both sections of the tax code, the taxpayer can maximize their wealth. In situations where the taxpayer has gains far exceeding the primary residence exemption, the combination of the tax strategies is a very effective means of preserving a taxpayer's wealth.

Another strategy is whereby a taxpayer converts a previously purchased 1031 replacement property into their primary residence. They will have to hold the replacement property for a period of time to satisfy the investment intent requirement, but after such time, the taxpayer could elect to move into the property as a primary residence. After living in for several years, the taxpayer may be eligible for the primary residence exemption upon the sale of the property. By utilizing such strategy, the taxpayer has effectively converted a deferral of gain to an exemption of gain. The Service has clawed back on such strategy by implementing more stringent requirements to qualify for IRC §121 to include a five year holding requirement and also a pro-rated exemption amount excluding periods of non-qualified use.

Furthermore, in situations where a taxpayer will have a gain far in excess of the primary residence exemption, the taxpayer could elect to move out of the property and rent it out for several years. At the time of sale a few years later, the taxpayer could qualify for both IRC §121 (as they lived in the property two out of the last five years) and IRC §1031 (at the time of sale the property will have been established as an investment property). In this scenario, the taxpayer can benefit from the primary residence exemption, while utilizing the 1031 exchange to defer the tax on the gain in excess of the exemption amount.

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