

Converting a Principal Residence to Minimize Taxes by Combining IRC §1031 and §121

When the Exchanger's principal residence is used partially for business purposes, such as a home office or a duplex, half of which is rented, then the Exchanger must allocate between the personal use and the business use. The portion allocated to business or investment purposes qualifies for an IRC §1031 exchange and the residence portion may qualify for the exclusion from capital gain for personal residences under IRC §121. Or, if a taxpayer uses a dwelling unit as his principal residence and then converts the home to a rental property, the taxpayer may be able to combine IRC §121 and §1031 to maximize deferral of capital gain.

Section 121 permits an exclusion from realized capital gain of \$250,000 for a single person and \$500,000 for a married couple on the sale of a home used as a primary residence for any two of the past five years. Section 3092 of the Housing & Economic Recovery Act of 2008 (H.R. 3221) added a limitation to IRC §121(b), requiring that the maximum exclusion will be reduced, based upon the ratio of time that the primary residence had a non-qualified use (after 12/31/08) during the taxpayer's ownership that either preceded the home's use as a primary residence or occurred between periods of use as a primary residence. Additionally, §121(d) requires that a residence acquired as a replacement property in a §1031 exchange must be held by the Exchanger for a total of five years before it will qualify for the §121 capital gain exclusion on sale.

IRC §1031 permits the deferral of realized capital gain by exchanging property that has been held for investment or used in a trade or business for like-kind investment or business use property of equal or greater value. Property currently used as the taxpayer's principal residence will not qualify for a §1031 exchange, but a residence that has been converted into use as a rental property for a period of time prior to sale may qualify both for a §1031 exchange as property used in a trade or business and also for the §121 exclusion. Revenue Procedure 2005-14 provides guidance on the concurrent application of IRC §121 and §1031. Consultation with a tax advisor is important whenever a taxpayer changes the use of a property, and to determine whether and to what extent IRC §121 and §1031 can be of benefit.

Brief Exchanges

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