

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



IRC §1031 permits the deferral of tax on gain from investment or business use property that is exchanged for like-kind investment or business use property of equal or greater value. The taxpayer's current principal residence, being personal use property, will not qualify for a §1031 Exchange. However, a taxpayer selling a primary residence that has been converted into use as a rental property for a period of time prior to sale, or that has been used partially for business purposes, such as a home office or a duplex, half of which is rented, may be able to combine IRC §121 and §1031 to maximize deferral of capital gains tax.

When the Exchanger's principal residence is used partially for business purposes, 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. Revenue Procedure 2005-14 provides guidance on the concurrent application of IRC §121 and §1031.

§121 permits an exclusion from realized capital gain of \$250,000 for a single person and \$500,000 for a married couple (filing jointly) on the sale of a home used as a primary residence for any two of the past five years, but there are some limitations. IRC §121(b) requires the maximum exclusion to 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)(10) 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 any §121 capital gain exclusion.