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One sale, two tax breaks: How to use sections 121 and 1031 together - by Pamela Michaels

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In and around New York City and in the Northeast generally, many property owners occupy property which is partially used as their primary residence and partially used for their business or as rental property. Examples of this abound on the Upper West and East Sides of the city where historic townhomes have been converted from use by one occupant to use by several.

A property owner selling such a townhome or a duplex, triplex or fourplex, where the owner lives in one unit and rents out the remaining units, can use two tax code sections and receive excellent tax advantages!

The unit where the owner lives is considered their primary residence and can qualify for exclusion of capital gain taxes as described below under “IRC § 121 - Benefits of Selling a Residence.” The capital gain taxes associated with the remainder of the multifamily property can qualify for tax deferral by performing a §1031 tax deferred exchange on the rental units. All this is possible even though there is one buyer for the entire complex.

§121—Benefits of Selling A Residence

The 1997 Taxpayer Relief Act provided homeowners significant tax advantages on what is considered their primary residence. §121 of the tax code allows a homeowner to exclude capital gain taxes if they meet the following requirements:

Couples filing a joint tax return can exclude up to \$500,000 of the capital gain on the sale of their primary residence, and single filers can exclude up to \$250,000; and

The home must have been the primary residence of both spouses for 24 of the last 60 months.

This exclusion is available every two years.

Combining the Benefits of §1031 and §121

There are two ways a taxpayer can use §1031 and §121 together. Both ways are known as split treatment transactions in the industry.

Split treatment: Part business/investment and part principal residence (a portion of the property treated as §1031 and a portion treated as §121);

Split treatment: 100% of the property qualifies as §1031 property (held for use in a trade or business or for investment) on the date of sale but two of the last five years the property was occupied by the taxpayer as his or her primary residence.

Let's see some examples of each of these options:

Portion §121 (residence) and a Portion §1031 (used in a business or held for investment)

In this example, a portion of the property is primary and a portion is investment or business property. 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 Qualified Intermediary (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.

The following is an example of a transaction meeting the above description: 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 being sold to a buyer for \$2 million. All units are valued equally so that each unit is valued at \$500,000. At closing the \$500,000 of value allocated to the primary residence is paid directly to the taxpayer less $\frac{1}{4}$ of any outstanding mortgage debt and exchange expenses and the balance of \$1.5 million less $\frac{3}{4}$ of the mortgage debt and $\frac{3}{4}$ of the exchange expenses is paid directly to the QI. The taxpayer must—in advance of closing—engage a QI 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.

Former Principal Residence Converted into a Rental Property (§121 converted to §1031)

Many residents of New York City have occupied their primary residence for many years. The result given rising values in the city and elsewhere in the Northeast is that upon sale, the relief provided by §121, exempting a maximum of \$500,000 of gain from taxation, does not do much to dent the tax bill. For example, consider a married couple who purchased their condominium at 30 East 61st St. in New York City 15 years ago for \$250,000. It is now appraised at \$2.5 million. If the couple were to sell the unit, even after their §121 exemption, they would be subject to gain on approximately \$1.75 million and when combined federal, state and local taxes are calculated they would be subject to a significant tax bill. So what strategy might be employed to mitigate these tax consequences? If the couple is financially able, the couple might put the sale on hold, move out of the residence and

convert it to rental property simultaneously establishing a new primary residence. Then after renting the property for two years, proceed with the sale. At the time of the sale, the property is 100% §1031 property but two of the last five years it was their primary residence. Thus, at closing \$500,000 goes directly to the couple tax free and the balance of the proceeds can be paid to the QI engaged to facilitate the client's exchange.

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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