

Combining a 1031 Exchange with an IRS Sec 121 Exclusion The Best of Both Worlds! **by Anne R. Baber**

A new tax ruling is good news for taxpayers who converted their primary residence into a rental unit. They may qualify for the Universal Tax Exemption (121 exclusion) and now they can combine this with a 1031 Exchange. This allows the taxpayer to defer capital gains liability in excess of the universal exemption.

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Section 1031 Exchanges

A 1031 tax-deferred exchange allows you to sell your income property (relinquished property) and defer your capital gain taxes by acquiring a like-kind replacement property.

To qualify for a like-kind tax deferred exchange, the property must have been purchased with the intent to hold for investment purposes and not for personal use purposes.

Section 121

You may already be familiar with a Section 121 Exclusion where you can sell your primary residence and exclude from taxable income up to \$250,000 (single taxpayers) or \$500,000 (married taxpayers filing jointly) in capital gains, if you have lived in your primary residence for at least 2 years out of the last 5 years.

You do not have to reinvest the proceeds from the sale of your primary residence and you can take advantage of this structure every two years.

Combining Sections 1031 and 121(b)

Combining these two tax strategies on owner occupied/income property has been done for years.

Example: if you own a duplex, and live in one half of the property as your primary residence and rent the second unit to a tenant, you may complete a 1031 tax deferred exchange on the rental portion and take the universal exemption (Sec 121 exclusion) on the portion that is your primary residence when you dispose of the property.

Combining Sections 1031 and 121 (a)

Section 121 (a) is a new IRS ruling effective January 27, 2005. This new ruling is indeed good news for taxpayers.

Section 121 (a) provides that a taxpayer may exclude gain realized in the sale or exchange of property if the property was owned and used as the taxpayer's principal residence for at least 2 years of the last five year period ending on the date of the sale or exchange.

In general, taxpayers within the scope of this revenue procedure may apply both the exclusion of gain from the exchange of a principal residence under section 121 and the non-recognition of gain from the exchange of like-kind properties under Section 1031. The Section 121 must be applied to the gain realized before applying Section 1031.

Example: You owned and lived in a duplex (one half) for 8 years. Two years ago, you moved into a house and converted your unit into a rental unit. Now, under the new ruling, you can dispose of your duplex and first apply the universal exemption (\$250,000 for singles and \$500,000 for a married couple filing jointly) and then apply Sec 1031 treatment to the remainder of the gain, thus deferring your tax liability.

Combining Sections 121 (d) and 1031- FIVE YEAR HOLD

A new law became effective October 22, 2004 and applies to the sale of one's primary residence if it was purchased as part of a 1031 exchange.

Under this provision, a taxpayer who exchanges into a rental house which is later converted into his primary residence is not allowed to exclude gain under the principal residence exclusion ruled of Section 121 (universal exemption) unless the sale occurs at least five years from the date of its acquisition.

Example: a taxpayer purchased a rental house two years ago and then moved into it as his principal residence. Under the new law, he will have to wait three more years before selling the property and excluding gain under Section 121. The taxpayer still must meet the two out of five-year occupancy test.

*If you would like a free,
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please give Anne a call...*

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Combing these two sections of the IRS code for income property is a powerful tax planning strategy that one may want to consider, however; you should only consider entering this type of structure after consulting with professional tax advisors.

If you would like a *free, easy to read, 21 page booklet on 1031 Exchanges* and/or a free copy of the Internal Revenue Bulletin, please give Anne a call at (818) 235-1135.

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