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The great real estate tax break: Combining a like kind exchange and the principal residence exclusion - by John Starling

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An exchange may qualify under Internal Revenue Code 1031 (I.R.C. § 1031) when the taxpayer's property is partially a personal residence and partially qualifying investment or business property under I.R.C. § 1031. This is sometimes called "mixed use" property. Many people find themselves owning a single property that has mixed use. For example, one unit of a two family duplex is occupied by the owner as a primary residence, while the other unit is rented out, or a farm that includes a farmhouse. Another common example is an accessory dwelling unit in the taxpayer's principal residence such as a garage apartment. Alternatively, a business use may be part of the personal residence space, such as the rental of bedrooms in the principal residence, or a home office or daycare use in part of the residence. Fortunately, the IRS allows the property owner to utilize two separate tax codes to defer capital gains tax on a portion of the sale and exclude taxes all together on the other portion. One tax code is available for primary residence (code 121) while the other is available for only investment or business properties (code 1031). Let's review each tax code and how we can combine them for maximum tax savings.

The Internal Revenue Code 121 (I.R.C. § 121) provides that a taxpayer, regardless of age, may exclude up to \$250,000 (\$500,000 for married persons filing jointly) of gain on the sale or exchange of his or her principal residence if, during the five-year period ending on the date of sale or exchange, the property has been owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating two years or more. A taxpayer may take advantage of the gain exclusion under I.R.C. § 121 no more than once every two years.

The IRS exchange code 1031 allows taxpayers to sell an investment property and defer the tax on the profit from the sale by investing the proceeds into a replacement property of equal or greater value. Both the relinquished and replacement need to be held for investment use. The taxpayer will need to engage a qualified intermediary to facilitate the exchange and adhere to the strict IRS guidelines to complete the exchange. The qualified intermediary is required to hold the proceeds of

the sale so the exchanger does not have constructive receipt of the funds. In addition, the exchanger must identify up to 3 replacement properties within 45 days of the sale of the relinquished property and complete the exchange by purchasing one or more of the named replacement properties within 180 days. For this article let's review two of the many scenarios in which you can combine a 1031 exchange with a 121 primary residence exclusion:

1. Converting a primary residence to an investment property will qualify for the tax code combination. Example: A couple has lived in a property for 5 years. They originally purchased the property for \$250,000 and after 5 years of ownership, it is valued at \$1.25 million. The 121 code allows a married couple to exclude \$500,000 in gains from taxation. So, because their potential gain on the additional profit, would require them to pay \$150,000 in tax even after the \$500,000 exclusion they decide to move and rent the property for two years, converting it to an income property. After two years, the couple can utilize code 1031 exchange because they rented the property for the last two years and utilize the 121 tax code to exclude \$500,000 from tax, because they lived in the property as their primary residence for two of the last five years. In this scenario, the taxpayers took \$500,000 in cash with no tax due and used the additional \$750,000 to complete a 1031 exchange by purchasing two investment properties to rent and paid no tax.

2. Multiple unit property. Example: A couple owns a two family house and utilizes one half as a primary residence and the other half is rented. As in the prior example the property has been held for 5 years and is valued \$1 million higher than the original purchase price of \$250,000. Upon the sale of the property, the taxpayers will be able to take the 121 exclusion and combine it with a 1031 exchange, deferring or excluding all the taxes. A replacement duplex can be purchased for \$750,000 and \$500,000 can be placed in savings or used to purchase another primary residence allowing the approximately \$150,000 that would have been paid to the IRS to help the couple grow their wealth much faster by utilizing the codes.

It is essential to understand the tax liability, tax basis and ownership structure. Consult your CPA or tax preparer and a qualified intermediary that is a certified exchange specialist to help guide you through the process. Most importantly, it is critical to engage a qualified intermediary prior to sale of property being relinquished. Northern 1031 Exchange helps guide exchangers through this complicated process to ensure a smooth and successful exchange.

In the next article let's talk about the "Required Holding Period for an Investment Property, is it... 2 years?... 1 year?... 6 months? or none of the above." Look for us in future NEREJ publications or if you have a question now, call direct!

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