Using IRC Section 121 the “Principal Residence Exclusion” and IRC Section 1031 tax-deferred exchange in the same transaction - by Brendan Greene

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Internal Revenue Code (IRC) Section 1031 allows a property owner, who holds property for “the productive use in a trade or business or for investment”, to defer paying capital gains taxes if a property owner sells such property, identifies like-kind property within forty-five days of the sale, and acquires other like-kind property within one hundred eighty days of the sale.

IRC Section 121, the so-called “Principal Residence Exclusion” allows sellers/taxpayers of principal residences to EXCLUDE up to $500,000 in capital gains taxes (if married and filing jointly) or up to $250,000 (if filing as an individual) so long as the taxpayer has lived in the property two out of the last five years. So, in order to have the principal residence exclusion, if one looks back from the date of sale and the taxpayer lived in the property two out of the last five years, then the taxpayer would be eligible for the principal residence exclusion.

However, the question that arises is whether a taxpayer can use both IRC Section 121, the principal residence exclusion and an IRC Section 1031 tax deferred exchange in the same sale.

IRS Revenue Procedure 2005-14 indicates that it is possible. For instance, Section 4 of the IRS Revenue Procedure 2005-14 states “Taxpayers within the scope of this revenue procedure may apply both the exclusion of gain from the exchange of a principal residence under IRC Section 121 and the nonrecognition of gain from the exchange of like-kind properties under IRC Section 1031 to an exchange of property by applying the procedures set forth in this section 4”.

For example, on January 15, 2018, John Taxpayer buys/builds a principal residence which cost him in total $1 million. John lives in the property with his wife until January 15, 2022. Then John and wife decide to rent the property from January 16, 2022 until April 1, 2024, at which time he sells the property for $3 million. John’s gain is $2 million (plus any depreciation he took during the time he rented the property). John and his wife would be eligible for the $500,000 IRC Section 121 Principal Residence Exclusion because, if you look back from January 16, 2024, John and his wife lived in the property for two out of the last five years.

In addition, John would be eligible to defer the other $1.5 million capital gain using a 1031 tax-deferred exchange if John identifies like-kind replacement property within forty-five days of the sale and closes on such property within one hundred eighty days of the sale. John would have met the requirements of IRC Section 1031 as the property was held as rental investment property for over two years at the time of sale.

Like-kind property includes all real estate; that is, any type of real estate may be considered “like kind” to any other type of real estate so long as both the relinquished property and the replacement property are used for investment or business purposes. If both the relinquished property and the replacement property are used for investment or business purposes, then a three-family rental property may be exchanged for a single or multi-family rental home; or a rental condominium unit could be exchanged for a retail shopping center.

In summary, with proper tax planning, 1031 tax-deferred exchanges coupled with Section 121 exclusion provide homeowners with great opportunities not only to exclude up to $500,000 in capital gain but also to defer any excess beyond the $500,000 limit.

The use of Section 1031 and Section 121 together with the sale of a significantly appreciated principal residence can be a very effective tax-planning strategy.

There are many technical tax and legal rules that must be followed in order to achieve tax-deferral treatment under IRC Section 121 and Section 1031.

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