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Overview of Combining a 1031 Exchange with a 121 Exclusion

Combining the 1031 exchange with the 121 exclusion can be one of the most powerful income tax planning tools available to you. This article will give you a brief overview of this combined tax planning strategy. It will also outline and incorporate the various legislative acts and IRS rulings that have impacted your ability to implement the various structures.

Legislative Acts and IRS Rulings

Congress enacted the [American Jobs Creation Act of 2004](#) and then the [Housing and Economic Recovery Act of 2008](#). These two Acts both amend Section 121 of the Internal Revenue Code adding restrictions as to how you can take advantage of the tax free exclusion when your property was previously held and used as investment property.

The Department of the Treasury issued [Revenue Procedure 2005-14](#) and then [Revenue Procedure 2008-16](#). These two Revenue Procedures actually provide very helpful and favorable guidance for the structuring of your 1031 exchange transactions.

1031 Exchange — Investment Property

[Section 1031 of the Internal Revenue Code](#) ("1031 exchange") provides that property held as rental or investment property or property used in your business ("relinquished property") can be exchanged for "like-kind" property also held as rental or investment property or property used in your business ("replacement property") allowing you to defer your Federal, and in most cases, state capital gain and depreciation recapture income tax liabilities.

The 1031 exchange can only be used with property that has been held for rental, investment or use in your business. It does not apply to property held for personal use such as your primary residence, second home or vacation property, although certain exceptions may apply as outlined in [Revenue Procedure 2008-16](#).

121 Exclusion — Primary Residence

[Section 121 of the Internal Revenue Code](#) ("121 exclusion") provides that property held and used by you as your primary residence for at least 24 months out of the last 60 months can be sold and you can exclude from your taxable income up to \$250,000.00 in capital gains if you are single (per homeowner/person) and up to \$500,000.00 in capital gains for a married couple filing a joint income tax return.

The 121 exclusion can only be used in conjunction with real property that has been held and used as your primary residence. It does not apply to second homes, vacation homes, or any kind of property that has been held for rental, investment of use in your business except where a combined 1031 exchange and 121 exclusion strategy is appropriate.

You can only exclude capital gains (not depreciation recapture) from your taxable income when you sell your primary residence that was also held as an investment property. The depreciation recapture would be recognized in the year the primary residence is sold even if you qualify for the 121 exclusion.

Income Tax Strategies

However, with very careful and proactive income tax planning, it is possible to combine the benefits of the 1031 exchange with a 121 exclusion. There are three (3) possible scenarios when combining a 1031 exchange with a 121 exclusion, which are outlined below.

Rental Property Converted to Primary Residence (No Prior 1031 Exchange)

The first scenario consists of rental property that you acquired out right (i.e. it was not acquired as part of a prior 1031 exchange transaction), which you decide to convert into your primary residence so that you can take advantage of the \$250,000.00 tax-free exclusion per homeowner/person (\$500,000.00 for a married couple filing a joint income tax return) pursuant to the 121 exclusion.

The only requirement with this strategy is that you move into the investment property (i.e. convert it from investment property into your primary residence) and live in and use it as your primary residence for at least 24 months. Once you have lived in and used it as your primary residence for at least 24 months you can sell the property and qualify for the 121 tax-free exclusion.

You will only qualify for a partial tax-free exclusion since the property was held and used as investment property prior to you converting it into your primary residence. There is an exception to this requirement. Rental property usage prior to January 1, 2009 is ignored. The more time the property is held and used as your primary residence the more gain that can be excluded from your taxable income.

Rental Property Converted to Primary Residence (Prior 1031 Exchange)

The second scenario is virtually identical to the first scenario except that you acquired the investment property as your like-kind replacement property in a prior 1031 exchange transaction.

In this case, because you acquired the real property as your like-kind replacement property in a prior 1031 exchange, you should hold the property as investment property for 12 to 18 months or more in order to demonstrate that you had the intent to hold the like-kind replacement property for investment. You will then move into the investment property after the 12 to 18 months and convert it into your primary residence. You must live in and use it as your primary residence for at least 24 months.

The American Jobs Creation Act of 2004 added one additional requirement that applies when your property was originally acquired as part of a prior 1031 exchange transaction. You must now hold or own the property for a minimum of five (5) years before you can qualify for the 121 exclusion. You do not have to live in the property for five (5) years; you only have to own it for five (5) years.

You will only qualify for a partial tax-free exclusion since the property was held and used as investment property prior to you converting it into your primary residence. There is an exception to this requirement. Rental property usage prior to January 1, 2009 is ignored. Again, the more time the property is held and used as your primary residence the more gain that can be excluded from your taxable income.

Primary Residence Converted to Rental Property

The final scenario consists of you (and your spouse, if applicable) owning, living in and using a property as your primary residence. The challenge is that your capital gain significantly exceeds the \$250,000.00 (or \$500,000.00) tax-free exclusion permitted under the 121 exclusion, and if you sell your property the amount of capital gain that exceeds the 121 exclusion limitation would be painfully taxable.

The Internal Revenue Service issued [Revenue Procedure 2005-14](#), which allows you to move out of your primary residence and convert it into investment property. The question is how long must you hold the property as investment property? Exeter recommends holding the property as investment property with absolutely no personal use for at least 12 months or longer in order to demonstrate that you did in fact have the intent to hold the property as investment property. Once you have held the property for a sufficient period of time, you can sell the property and qualify for the 121 tax-free exclusion and for a 1031 exchange so that you can defer the balance of the capital gain into more investment properties.

You would sell the property, exclude the \$250,000.00 or \$500,000.00 in capital gains from your taxable income and complete a 1031 exchange for the balance of the sale transaction to defer the rest of your capital gain, including any depreciation recapture, into the purchase of another like-kind rental property.

It is a great income tax planning strategy when you have a highly appreciated primary residence.