COMBINING PRIMARY RESIDENCE EXCLUSION WITH A 1031 EXCHANGE USING REV PROC. 2005-14

There are some instances where, for tax purposes, real property can be treated both as property held for investment or business purposes *and* as a primary residence. This can result in the exclusion and/or deferral of capital gains using multiple sections of the Internal Revenue Code ("IRC"). Revenue Procedure 2005-14 provides specific guidance on the application of §§ 121 and 1031 of the Internal Revenue Code to a single disposition of property.

IRC § 121 – Primary Residence Exclusion

§ 121 of the IRC provides that a taxpayer may exclude up to $250,000 of capital gain (or up to $500,000 if married and filing jointly) on the sale of one's primary residence. The specific requirements for such an exclusion are as follows:

- Property must have been owned and used by seller as the seller's primary residence for 2 of the last 5 years;
- Exclusion only applies to gain accrued while property was being used as primary residence;
- Cannot exclude gain attributable to depreciation taken after 1997; and
- Exclusion may only be used once every two (2) years.

IRC § 1031 – Exchange of Property Held for Investment or Business Purposes

§ 1031 of the IRC allows taxpayers to defer the capital gains that would arise from the sale of a property *held for investment or business purposes* by reinvesting the proceeds into a new, like-kind property of equal or greater value. This deferral includes Federal capital gains tax, state income tax, the Net Investment Income Tax, and depreciation recapture.

Common Examples using Revenue Procedure 2005-14

The two most common situations where Revenue Procedure 2005-14 comes into play are: (1) when a taxpayer converts their primary residence into an investment property; and (2) when a taxpayer treats one portion of his or her property as a primary residence and another portion an investment property. For the purposes of simplicity, both examples below assume there is no debt on the property when it is sold.

<u>Example #1 – Converting Primary Residence into Investment Property</u>

Lucy purchases a home in 2010 for $500,000 and lives in it as her primary residence. In 2017 she decides to move out of the house and start renting it out on Air BnB. After renting it out for 2 years, she decides to sell the house in 2019 for $900,000. Let us assume that her adjusted basis in the house is $500,000. Consequently, Lucy will realize a gain of $400,000 ($900K sale price *minus* $500K adjusted basis).

Since Lucy had been renting out the house for last 2 years before she sold it, she was successfully able to convert the house into "investment property" that would qualify for tax deferral under IRC § 1031. *Revenue Procedure 2008-16*. In addition, Lucy lived in the house as her primary residence for 2 out of the last 5 years before she sold it, so she can also exclude a portion of her capital gain under the IRC § 121 primary residence exclusion.

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So, what can Lucy do about her $400,000 capital gain? First, as noted above, she can exclude $250,000 of the gain under the IRC § 121 primary residence exclusion. In addition, she can defer the remaining $150,000 of gain, by reinvesting the remainder of the net proceeds into a new investment property worth at least $650,000 ($900K sale price *minus* the $250K exclusion she took), with the usual rules of a 1031 exchange applying.

The net result for Lucy is being able to keep $250,000 of the cash from her sale tax free, and then deferring the taxes on rest of her gain by doing a 1031 exchange.

<u>Example #2 – Selling a Multi-Family or Mixed-Use Property</u>

John and Yoko are a married couple that buy a duplex in 2012 for $1,000,000. They rent out one unit and live in the other unit as their primary residence. In 2019, they decide to sell the duplex for $1,600,000. In the years that John and Yoko filed taxes while owning the duplex, they took a total of $40,000 in depreciation on the 50% of building that was allocated to the rental unit. John and Yoko's capital gains and depreciation recapture will be calculated as follows:

	Value	**Depreciation Taken**	**Adjusted Basis**	**Gain + Depreciation Recapture**
Primary Residence Unit	$800,000	$0	$500,000	$300,000
Investment Unit	$800,000	$40,000	$460,000	$340,000

When John and Yoko sell the duplex, they will be able to use the IRC § 121 primary residence exclusion to exclude the $300,000 of gain on the primary residence unit (remember, you can exclude up to $500K in gain if you are a married couple). In addition, they will be able to defer the $340,000 of capital gain and depreciation recapture on the investment unit by doing a 1031 exchange and purchasing investment property worth at least $800,000 (i.e. the value of the investment portion of the property being sold). Again, the usual rules of a 1031 exchange would apply.

The net result for John and Yoko is they can exclude all capital gain from the sale of their primary residence unit and keep the entire $800,000 of sale proceeds from that portion of the duplex. In addition, they can defer their entire $340,000 in capital gains and depreciation recapture on the investment unit by doing a 1031 exchange.

As always, please have your tax adviser evaluate the combination of combining primary residence exclusion with a 1031 Exchange to avoid any unexpected tax consequences.

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