

## THE POWER OF SECTION 121

### *Sale of Personal Residence*

The sale of your personal residence can be a stressful event; all that packing, arranging for the big day and the transfer of your sacred home to new owners is enough to bring you to your knees. And then, suddenly you think, “what about the taxes?” The good news is that Section 121 of the Internal Revenue Code provides for an exemption from gain upon the sale of your home if it has been your primary residence for two of the past five years. The exemption amount is \$250,000 per individual or \$500,000 for a married couple filing jointly.

There are numerous ways to utilize Section 121 without triggering tax. The biggest hurdle is to meet the residency requirement of 2 of the last 5 years. It doesn't matter if you are residing in the property at the time of sale as long as you meet the 730-day residency test. There is no requirement to reinvest the sale proceeds in another primary residence or any real property for that matter. If you acquire a new personal residence without selling your existing property, you have three years from the move out date to still utilize Section 121 before paying capital gains tax. This presupposes that you have not used Section 121 to exclude gain on any other property in the meantime. It can only be used every two years.

But what do you do if the gain amount exceeds the limitations? One practical answer is to take back financing for the excess amount using the installment sale method, thereby deferring the payment of tax until the actual receipt of the funds, presumably, over time. There is risk in positioning yourself as the lender, so beware. The other possibility is to create a structured sale by assigning the contract for the excess amount to a third party (usually an insurance company utilizing an annuity) who will provide a fixed return based on time and value.

As you can see, if the gain amount exceeds the limitations then you need to be more strategic in your planning. Another possibility is for the property to be occupied by yourself, your wife and one of your offspring (or other family member) for two of the last five years and to have the ownership of the property as tenants-in-common naming all three in the deed. Upon sale of the property, each party is entitled to a \$250,000 exemption from tax. Of course, all of this requires good planning and residency by all three parties.

Review the make up of your primary residence asset; does it contain excess land that has been held for investment during your ownership or has part of the property been utilized for business purposes, such as a home office? If any of these scenarios fit, then you need to examine how Section 121 can be used in concert with Section 1031 simultaneously to defer the gain on the sale of the investment/business portion of the property. A clear differentiation in the books and records of the taxpayer on the portion of the property that has been used for business versus the portion that is used for personal use must be present. A classic example is the taxpayer that has operated an owner occupied bed and breakfast, using the property as part personal residence, part business property. Section 121 provides partial protection from tax and Section 1031 provides additional protection as long as the business/investment portion is reinvested into “like-kind” property within 180 days and handled by a Qualified Intermediary.

Section 1031 can be an effective strategy on the sale of a primary residence that contains excess land surrounding a personal residence (investment property). For example, a taxpayer owns a personal

residence situated on 25 acres of land. It has been determined that the usual and customary acreage for similar properties in the vicinity is 3 acres. If the taxpayer has been holding the 22 excess acreage for investment, then that portion of the property can be treated as an exchange. A case in point: if the total value of the property is \$800,000.00 (assuming very low basis) and the residential exclusion can be utilized for up to \$500,000.00 of the gain, then it is possible to protect the \$300,000.00 balance as a tax deferred exchange and avoid any capital gains tax. The land value must support the excess value being claimed.

Taxpayers selling their mixed use property must be aware that they will be subject to capital gains on the sale of the business portion of the property at the rate of 15% and recapture of past depreciation at the rate of 25% if they don't use the provisions of IRC Section 1031. Further, many states also impose a capital gains and/or business profits tax that could be due upon the sale of the property.

It is easy to see the Power of Section 121 and 1031 and the many options that are available on the sale of your personal residence and business/investment property. Whether Replacement Property is the desired goal or a combination of cash, new property, installment sale or tax-deferral, Section 1031 can provide the pathway to building a solid financial future.