Exchanges of Mixed Use Properties

A valid 1031 exchange can be created when the taxpayer's property is partially a personal residence and partially qualifying property under section 1031. Common examples include: a fourplex in which the taxpayer rents three units and resides in one unit; a home office or other portion of a home exclusively used for business; and a farm or ranch that includes a residence.

This involves two sections of the Internal Revenue Code; Section 121 and Section 1031. Section 121 (sometimes called the Home Gain Exclusion) provides that a taxpayer can exclude from income up to $250,000 of gain ($500,000 if married and filing a joint return) if the dwelling has been their primary residence for two of the last five years (24 of the past 60 months). It is not required that use as a primary residence occurred in the most recent 24 month period prior to sale or even be a continuous use for 24 months. The only requirement is that during the 60 month period prior to sale, it was used as a primary residence for at least 24 months.

Combining the two sections allows the seller of a mixed use property to take some cash out of the sale without paying taxes. Many taxpayers incorrectly believe they are entitled to the full amount of the exclusion. However, the $250,000 and $500,000 are limits for potential exclusion, not entitlements. The amount of the actual exclusion will be determined by the value of the residential use portion of the property.

For example, let's assume that Rob Rancher sells his ranch for $2 Million. Included in the sale is the ranch house that he has lived in for 15 years. Its value (and the surrounding personal use acreage) is $200,000. The limit of his section 121 exclusion is $200,000. The remainder of the $2,000,000 sales price ($1,800,000), the amount attributable to the qualifying property, would be part of Rob's 1031 exchange.

The taxpayer will need to support the allocation, if audited. The Tax Court in Yates v. C.I.R., T.C. Memo 2013-28 stated that allocations made in the purchase and sale agreement where the parties have adverse interests will be respected unless they are unrealistic. Once the allocation percentage is established, the entire sales price and closing expenses are allocated between the value of the personal residence and the qualifying property under section 1031. A tax adviser should be consulted for assistance with the allocation.

In Revenue Procedure 2005-14, the IRS provided guidance and helpful examples with respect to how these two sections of the Internal Revenue Code can be used together and discusses situations involving the same dwelling unit and separate dwelling units. Periodically a taxpayer may want to reinvest part or all of the sale proceeds attributable to the primary residence (for which gain was excluded under section 121) into the 1031 replacement property. Revenue Procedure 2005-14 provides that the tax basis of the replacement property acquired in the 1031 exchange is increased by the amount of the equity invested that was eligible for the 121 exclusion. When the taxpayer sells the replacement property, the value previously allocated to the original Section 121 reinvestment, now fully incorporated into the basis of the replacement property, will not be taxable.