IPX 1031 Investment Property Exchange Services, Inc.
A Subsidiary of Fidelity National Financial, a Fortune 500 Company

# 1031Insider

## Common 1031 Myths – Part III

There are countless myths and misconceptions about 1031 exchanges. What follows are a few of the myths heard over and over in our offices. Here we attempt to set the record straight.

**Myth #9 – 1031 is a *tax-free* strategy. – No, no, no.**

The IRS issued a fact sheet (FS-2008-18, March 5, 2008) reminding Taxpayers that 1031 exchanges are tax-deferred not tax-free. The tax bill doesn't go away with the exchange. The gain in the old property transfers to the replacement property. If at some point the Taxpayer sells the replacement property, without executing another exchange, the taxes come due.

**Myth #10 – If the Taxpayer holds the replacement long enough (or until they turn 55) the tax bill will go away.**

See the answer above. Tax-deferred is tax-deferred.

**Myth #11 – The Taxpayer can take $250k out of the sale of their rental, tax-free. – Again, no.**

A Taxpayer is only entitled to tax-free gain from the sale of a primary residence that they owned and occupied for two of the last five years. If they have a spouse they are each entitled to $250k for an aggregate of $500k. This rule does not apply to any other property they own and certainly not to rentals, commercial properties and land that are the subject of 1031 exchanges.

**Myth #12 – The Taxpayer can move into the replacement rental house and the tax bill will go away. – No longer.**

This used to be true - up to $500k for a Taxpayer and their spouse. (The sale would still be subject to depreciation recapture.) However, Congress amended the primary residence rules effective January 1, 2009. Now if the Taxpayer moves into the rental house and converts it to a primary residence and later sells the property - some of the gain will be tax-free. Some of the gain will be taxable.

The technical rule: Upon sale of the property the Taxpayer will have to create a fraction – the amount of non-qualified use (rental or second home use after December 31, 2008) over the number of years owned. The gain is multiplied by this fraction to determine the taxable portion. For example, if the property was owned for five years with two years of rental, two-fifths of the gain would be taxable. Three-fifths would be tax-free. (And of course, the sale would still be subject to depreciation recapture.)