

Converting a 1031 Exchange Property into a Primary Residence

Are you considering converting a rental or second home into your primary residence and curious about the tax implications when you sell? Understanding the rules and exclusions under the tax code can be complex. Whether you're planning to make the switch or already have, it's crucial to understand how much gain you can exclude from taxes and the impact of nonqualified use periods on your exclusion eligibility.

Generally, under Code Section 121, a taxpayer can exclude up to \$250,000 (\$500,000 for married couples filing jointly) of gain realized on the sale of a principal (primary) residence if they have owned and occupied the residence for two years during the five-year period preceding the date of sale. Gain related to depreciation deductions taken on the property since May 6, 1997, is not eligible for exclusion.

However, if the primary residence was converted from a residential property (second home or rental), the 121 exclusion will not apply to gain from the sale of the residence allocable to periods of "nonqualified use." Nonqualified use refers to periods that the property is not used as the taxpayer's principal residence, including use as a second home and as a rental. In addition, when a 1031 property is converted to a primary residence, there's a 5-year holding period post exchange.

▶ EXAMPLE 1

Single taxpayer exchanges into a residence and rents it for four years, and then moves into it and lives in it for two years. The taxpayer then sold the residence and realized \$300,000 of gain. The exclusion must be prorated as follows (the example does not take into account depreciation taken after May 1997, which is taxable anyway).

- Four-sixths (4 out of 6 years) of the gain, or \$200,000, would be ineligible for the \$250,000 exclusion.
- Two-sixths (2 out of 6 years) of the gain, or \$100,000, would be eligible for the exclusion.

In general, the allocation rules only apply to time periods prior to the conversion into a principal residence and not to time periods after the conversion out of personal residence use. Thus, if a taxpayer converts a primary residence to a rental and never moves back in and otherwise meets the two out of five-year test under Section 121, the taxpayer is eligible for the full \$250,000 exclusion when the rental is sold. This rule only applies to non-qualified use periods within the 5 year look back period of Section 121(a) after the last date the property is used as a principal residence.

▶ EXAMPLE 2

Single taxpayer with \$300,000 realized gain uses the property as a principal residence in years one through three, then rents the property in years four and five. In this scenario, taxpayer is entitled to the full \$250,000 exclusion.

▶ EXAMPLE 3

Single taxpayer with \$300,000 realized gain uses the property as a principal residence in years one and two, then rents the property for years three and four, and then uses it again as a principal residence in year five. The allocation rules apply as follows.

- Two-Fifths (2 of 5 years) of the gain, or \$100,000, would be ineligible for the \$250,000 exclusion.
- Three-Fifths (3 out of 5 years) of the gain, or \$150,000, would be eligible for the exclusion.

Importantly, use prior to January 1, 2009 is viewed as qualified use.

▶ EXAMPLE 4

Taxpayer exchanged into a property in 2007, rents it for 3 years until 2010 and then moves into it as a primary residence. If the taxpayer sold the residence in 2013 after three years of primary residential use, only the 2009 rental period would be considered in the allocation for the nonqualified use.

- One-sixth (1 out of 6 years – only 2009) of the gain would be ineligible for the exclusion.

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