

Converting Your Primary Residence Into Investment Property

▶ Combining Sections §121 and §1031 to Maximize Tax Benefits

The tax code allows you to keep some or all of the gain on the sale of a primary residence if you meet certain conditions. IRC §121 permits the exclusion of realized capital gain of \$250,000 for a single person and \$500,000 for a married couple upon the sale of a home that was their primary residence for any two years during the five years preceding the sale. If your gain is in excess of this exclusion, you may have to pay capital gain tax on the amount over the exemption. This exemption cannot be used more than once every two years.

Let's assume you have lived in your home as a primary residence more than two years but decide to move out and turn the property into rental housing. If you sell the property less than three years after you move out, you still qualify for that primary residence exemption of \$250,000 or \$500,000. So if your gain is less than those thresholds, you will have no tax to pay on your gain, though you will have to pay taxes on the gain due to depreciation (the amount of depreciation taken while it was a rental).

But what if your gain is in excess of the exemption? In 2005 the IRS issued Revenue Procedure 2005-14, which showed [how you can combine the primary residence exemption with a 1031 Exchange](#).

For example, you bought your house for \$200,000 and it is now worth \$900,000. After living in it for many years, you convert your house into a rental property. After renting the property for a couple years you have established the house as investment real estate, BUT you still meet the criteria of having lived in the property for two of the last five years. When you sell it, it qualifies under both sections §121 and §1031 of the tax code. That allows you to keep your exemption amount (either \$250,000 or \$500,000) in cash and do a 1031 Exchange with the remainder. If you are married, filing jointly, you can pocket \$500,000 and exchange the remaining \$400,000 towards another piece of investment real estate.

Lastly, if you do not sell the property in that three-year window after you move out, your property no longer qualifies for the primary residence exemption and is now fully investment real estate.

DISCLAIMER: The information above is based on current tax code, which is subject to change. The above information should not be considered to be tax advice. You should discuss your personal situation with your qualified tax advisor.

Please contact us for further information or to discuss your specific 1031 situation.

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