1031 Exchanges and Conversion Into a Primary Residence

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Many people know about the primary residence exclusion that allows them to take the first $250,000 in profit ($500,000 if you're married) tax-free after just two years of occupancy. And more and more people are learning about the opportunity to do that repeatedly. But, did you know that you can convert an investment property into your primary residence and take advantage of that tax break? Even if you used a 1031 Exchange in your investment property, it's still an option.

Converting from Investment to Primary Residence

Here's the deal on converting investment property into your primary residence:

- If you purchased the investment without a 1031 Exchange, you may change its use at any time. Simply use the property as your primary residence for two of the five years immediately preceding its sale.
- If you purchased the property with a 1031 Exchange, there are some special rules for the conversion and the exclusion is prorated.

Converting after a 1031 Exchange

As you may recall, you cannot use a 1031 Exchange to purchase a property you intend to use for your primary residence. You must use the 1031 to purchase property you intend to use for investment purposes.

However, you can convert a 1031 property into your primary residence after holding it for productive use in business or trade for a period of time. The key is:

- your initial intent to hold it for investment purposes and
- how you demonstrate that intent.

For example, if you 1031 into a property and then move right in, what was your demonstrated intent? To use it as your primary residence. Both your initial stated intent and your actions subsequent to purchase are key.

Special Rules after a 1031 Exchange

If you 1031 into a property and then use it as a rental for the next 24 months and do not use it for personal use for more than 2 weeks or 10% of the number of days it is actually rented, then the IRS gives you a safe harbor and will never challenge your initial intent. In between day one and two years, there is a wide range of time for you to decide if you've owned it long enough and treated it as an investment enough that you can change your intent and move in. An awful lot of folks feel good at anything more than a year. However, individual circumstances could allow a shorter (or longer) investment use period.

When you do convert the property into your primary residence, you will then get the benefit of the primary residence exclusion with some 1031 Exchange-specific requirements. To qualify for any of the primary residence exclusions, you must have owned the converted property for no less than five years. In addition, you must have lived in it for two out of the five years prior to sale. And then you get to prorate the amount of gain between the period of “qualified use” (as a primary and tax-free) and “non-qualified use” (as an investment and you would pay tax on this portion). You also have to recapture all depreciation.

The Bottom Line

The conversion of an investment property into your primary residence is an underutilized option that can be very beneficial. Over time, it can make the capital gains tax on your former investment property dwindle. This gives you the opportunity to take all or a portion of your home sale proceeds tax-free.

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