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## Converting Investment Property to a Primary Residence

Customers often ask, "How long must I hold a property for investment before I can 'safely' convert the property to my principal residence?" The reason for this question is because of the different ways principal residences and investment properties are treated by the Internal Revenue Code.

Internal Revenue Code Section 121 deals with the sale of principal residences. It can be summarized as follows: a taxpayer can sell a principal residence without ANY tax liability if a) the taxpayer has maintained the property as his principal residence for two out of the last five years, b) the taxpayer has not claimed tax exemption under this rule within the last two years, and c) the gain excluded does not exceed \$250,000 for a single individual, \$500,000 for a married couple.

Internal Revenue Code Section 1031 deals with the exchange of real property held for investment, or real property used in trade or business. It can be summarized as follows: any real property held for investment can be exchanged for any other real property held for investment without recognition of gain (without current tax liability) provided the taxpayer does not receive any non like kind property as part of the exchange.

Unlike Section 121, Section 1031 does not require any specific duration of ownership prior to transfer of the property. Neither does Section 1031 require any specific duration for which the acquired property must be held for investment. Taxpayers usually want to first use Section 1031 to exchange into investment property and avoid current tax liability. Then, the same taxpayer desires to convert the same property into a principal residence, and two years later use Section 121 to avoid all tax liability upon the sale of the property. Section 1031 requires that the taxpayer intends to use the property for investment. Whether a taxpayer intends to use a property for investment will be determined by all the facts and circumstances. What the taxpayer can not do is use Section 1031 to exchange into investment property and then, as part of a plan, convert the investment property to principal residence. Nevertheless, an unanticipated change in situations could lead a taxpayer to reasonably change the intended use of a property, converting the property from investment use to principal residence. Hypothetical examples of such changed situations might be: a change in the health of the taxpayer, a change in the economic condition of the taxpayer, a change in the investment potential of the property, or any other change of situation that reasonably justifies the conversion in use under the totality of the circumstances.

Conclusion: In order to combine the tax benefits of Section 1031 with Section 121, a creative lack of planning is required.

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