



## Converting 1031 Exchange Property into a Principle Residence

One of the pleasures I get from practicing in Florida as a CPA and 1031 exchange agent, or what the IRS terms “Qualified intermediary” (QI), is many of our clients look to the sunshine state to retire to someday. Further, as a CPA and experienced tax practitioner, I am in a unique position to guide them through a variety of retirement planning tools to get them to their goal. Properly planned and set into motion, one of the most creative and unique tax planning tools available to all real estate investors is to utilize 1031 exchanges to accomplish this objective.

In a 1031 exchange, a taxpayer sells *investment* property at a gain, and rather than pay tax on the gain, they take the money and buy a replacement investment property. If they follow the safe harbor rules of section 1031, including the hiring of a QI to set up the exchange and hold the money, the tax on the gain gets deferred and reinvested as “equity” into the new property.



Nace Cohen, CPA

One of the key requirements for a 1031 is that the property being exchanged must be “*held for investment*” in order to qualify for tax deferral. This means the property you are selling must be income producing, like a rental condo, single family home, townhouse, duplex, etc., and as long as there is rental activity claimed on the taxpayer’s tax return for at least a year or two, it’s going to be eligible for a 1031 exchange. Also, an investor holding land is always eligible, even if it’s not income producing, because most land sits vacant and held for appreciation.

Thinking this through, suppose Lori and Bob own a single family rental house near where they live in Ohio. They have owned it many years and can now sell it for \$400,000, all of which is gain due to appreciation and all the depreciation they took on it over the years. If they sell it, they are in a bind because they’re going to get hammered in taxes between federal and Ohio state income taxes. What they really want to do is sell the rental and use the money to buy property in Florida, where they can move to someday and retire. How can they do this and not pay tax on the sale?

The first step is they sell the rental and do a 1031 exchange for a Florida home, a home they want to retire to someday. Next, they rent that new Florida home for two years in order to qualify for the “held for investment” requirement of section 1031. After renting that 1031 house in Florida for a couple of years, they sell their Ohio home where they live for \$500,000, all of which is tax free. That’s right! When they sell the house where they live, i.e. their principle residence or homestead, section 121 of the IRC, a/k/a the home sale exclusion, says you can take up to \$500,000 of the gain tax free as long as they own, live, and use it as their principle residence for two (2) years out

of the previous five (5) years, and also haven't taken the home sale exclusion in the past two (2) years. They must also file a joint tax return. Single filers get \$250,000 tax free.

So Lori and Bob pocket the money from the sale of their homestead tax free, pack up the house, and move to Florida into the rental home they bought in a 1031 exchange a couple of years ago. Well, this is getting interesting!

Next, they "convert" that 1031 rental to their principle residence homestead. How to they do that? They file Florida homestead, change their drivers license, move all their bank accounts and mail to their new address in Florida, and basically announce to the world that Florida is their new home.

At this point, one question I always get asked is does the tax from the previous 1031 now have to be paid because Lori and Bob switched the property over from rental to personal use homestead? The answer is no, as the act of conversion is not a taxable event, only the act of selling would be. In addition, since they rented Florida for the first two years after the exchange, it satisfied the held for investment requirements of section 1031. At this point they have a green light to live there as long as they want and not have to worry about the tax until they sell it down the road.

Next, they live there for three (3) years after the 2 year rental period, and now are thinking about selling. They now sell for \$500,000, which is all gain. Of that, \$400,000 is 1031 rollover gain from their Ohio sale, and the additional \$100,000 is appreciation gain since they've owned it.

If you are thinking they can take the home sale exclusion again, up to \$500,000 tax free, well you would be correct if it was a few years ago. However, the IRS recently revised the rules a bit.

The new IRS rules say when you sell your homestead that was purchased in a previous 1031 exchange, you will need to prorate the gain between investment use and personal use. The investment gain portion gets taxed, but the personal use gain portion still qualifies for the exclusion to the 250k/500k amounts. In addition, if you want to utilize the homestead exclusion to eliminate the personal portion of the gain, you have to hold it a full five (5) years before you sell. But even if the IRS taxes a small part of it, what a great way to exclude most of the gain! If they hold it longer than 5 years, less tax will be due as more gain will be allocated to the personal use portion.

Also, and here's the bonus, Lori and Bob eliminated Ohio taxes entirely, because they deferred the Ohio tax into the Florida property. When they sell the Florida property down the road, it's not Ohio property, so no Ohio tax!

There's a few more things that will be required to sew this up tight, so get with an experienced CPA and QI before you attempt one of these as you will want to make sure your 1031 conversion to a principal residence will stand up to IRS scrutiny. In addition, and I stress this, talk to your CPA or tax advisor whenever you make major financial decisions such as selling real estate because each person's tax situation is different and unique.

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