

## Investment Property to Personal Residence Rollover

**Under the rules of IRC §121, gain on the sale of a personal residence is “tax-free” up to \$500,000** for married taxpayers filing a joint return (\$250,000 for single taxpayers) if the taxpayer has owned and lived in the residence for periods of time adding up to two years out of the previous five years.

**Subject to exceptions** taxpayers have long known that they could cash out of rental properties “tax-free” under the provisions of IRC §121 relating to the tax-free sale of a personal residence (the Section 121 exclusion). All they needed to do was move into a rental property, live there two years and then sell it “tax-free” as a personal residence. Converting a rental property to a personal residence is not a taxable event.

**What if the rental property is not suitable for a taxpayer to want to live in it for two years?** The answer is a 1031 Exchange for a property that will be suitable for the taxpayer. Astute real estate investors have also known that they can roll out of an investment property thru a 1031 Exchange and replace with a qualifying residential real estate investment property. They then rent it out for a year or so (exchange professionals recommend at least one year) before moving into it. Once they live in it for two or more years (and after owning the property for five years) they are eligible to take the Section 121 exclusion on a subsequent sale.

**The five year ownership requirement became effective October 22, 2004** with the American Jobs Creation Act of 2004. The Act imposed a new ownership requirement of five years for property received as replacement property in a 1031 Exchange. The two year residency requirement remained unchanged.

### The Exceptions

**Depreciation after May 6, 1997** - Any depreciation taken on the residence after May 6, 1997 is not eligible for the Section 121 exclusion and must be reported as income even if the home otherwise qualifies for the Section 121 exclusion.

**Non-Qualified Use** - The Housing Assistance Tax Act of 2008 reduced the benefits of the Section 121 exclusion on the sale of a personal residence. In a nutshell, any “disqualified use” of a residence after January 1, 2009 causes a fraction of the §121 gain to be not qualified for the exclusion. The fraction is calculated by dividing the period of time of nonqualified use by the total period of time the property is owned. Accordingly, any period of time after January 1, 2009 during which the residence was used for rental purposes is “non qualified use” and any exclusion under IRC §121 must be prorated to determine the part of the gain not eligible for the §121 Exclusion.

**Taxpayers converting investment property to their personal residence** thru a 1031 Exchange can still take advantage of the Section 121 exclusion for sale of a personal residence subject to the exceptions listed above. The longer the residence is owned; the smaller the non-qualifying percentage.

**Call us at 888-367-1031** or email us at [1031@1031cpas.com](mailto:1031@1031cpas.com) if we can assist with questions. See our Exchange Manual and visit us at [www.1031cpas.com](http://www.1031cpas.com). 1031 Corporation is the Intermediary of choice for real estate professionals, CPAs and investors.

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