Farr Law Firm Newsletter
Big City Solutions. Small Town Values.
April 2016 | Issue 4

# 1031 Exchanges

## Converting 1031 Property into a Principal Residence

**Jack O. Hackett II**
**TEL** 941.639.1158
**EMAIL** jhackett@farr.com

Jack is Board Certified by The Florida Bar in Real Estate and also practices in corporate and business law.

In order to qualify for non-recognition of gain under an Internal Revenue Code Section 1031 exchange (also called a like-kind exchange), both the property that you give up (the relinquished property) and the property you acquire (the replacement property) must be property held for productive use in a trade or business or for investment. This is sometimes referred to as the qualified purpose requirement.

By definition, your personal residence is not property held for investment or for use in a trade or business; therefore, it does not meet the qualified purpose requirement (although mixed use property may partially qualify – such as a duplex that you live in one unit and rent out the other or a home on the family farm). Thus, neither the relinquished property nor the replacement property in a 1031 exchange can be a personal residence. Also, holding a home simply with the hope that its value will go up does not constitute investment.

But what if your intentions change after you have acquired the replacement property? Is there a point at which you can move into the replacement property and convert it to your principal residence? And if you reside in it and own it the required periods of time, can you use IRC Section 121 to exclude up to $250,000 of gain ($500,000 for married persons filing jointly) on the sale of your principal residence?

It can be done, but the key is your intention at the time you acquired the replacement property. Did you honestly acquire it for investment purposes? Did you have a significant change in circumstances after the acquisition which caused you to move into the property? Can you prove your intention and that change in circumstances? If so, you may be able to re-characterize that 1031-deferred gain on investment property into gain on your principal residence and enjoy some or all of the $250,000 or $500,000 exclusion on its sale.

### What are the guidelines in doing this?

The principal question is your intent when you acquired the replacement property. If you sincerely intended to treat it as investment property and not to move into it at the first opportunity, then you are on the right track. How can you prove that intent? If you can't meet the safe harbor test discussed below, the best way is to actually use the property for investment purposes for a significant period of time after its acquisition. If you rent the house out at fair market value for at least a year (according to some commentators), then you likely have shown you acquired the property with investment intent. If you merely put up a good show, on the other hand, such as listing it for rent at an amount that is significantly higher than market, or not even listing it at all, the IRS will see right through that.

Other common sense evidence of intent can be gleaned from a review of the case law (i.e., other people's mistakes):

- Don't have plans drawn up for your principal residence or a vacation home just before or after the exchange.
- Don't move into the house right after the exchange, even on a temporary basis.
- Don't make the contract to acquire the replacement property contingent upon the sale of your principal residence.
- Use a reasonable and significant amount of advertising or listings in order to rent the property at a marketable rental amount.
- Document how you arrived at the asking price of the rent.
- Don't start construction on preparing the house for your personal use right after acquiring it.
- Make sure that the restrictive covenants of the replacement property (or condo documents) allow it to be rented out.
- Document your efforts to rent the house out including names and contact information for potential tenants who looked at it. You may need to call them as witnesses!
- If you have a change of circumstances that caused you to move into the house, make sure to document that. Did you unexpectedly lose your job, get sick, disabled, divorced, married, or have to take in an elderly parent?

As mentioned above, the IRS has provided a safe harbor for determining how long a replacement property must be held as a rental before converting it into a primary residence or vacation home without invalidating the prior exchange. The replacement property must be owned for at least 24 months immediately after the exchange (the qualifying period) and in each of the two 12-month periods in the qualifying period: (1) the taxpayer must rent the replacement property to another person at a fair rental for 14 days or more; and (2) the taxpayer's personal use of the replacement property must not exceed the greater of 14 days or 10% of the number of days during the 12-month period that the dwelling unit is rented at fair rental. It can be rented to a family member as a principal residence so long as market rent is paid.

In order to qualify for the Section 121 exclusion of gain, you must use the home as your principal residence for at least 2 of the last 5 years prior to its sale. Also, Section 121 has a special rule for 1031 property that states that you have to own the home for at least 5 years (either as 1031 property or principal residence) before you sell it. Finally, the amount of the exclusion you can claim will be prorated between the period of time it was your principal residence and the time that it wasn't, and any depreciation you took will be taxable.

This is an area where each person's facts and circumstances are different, so before you get too far down the path of converting a 1031 property to a principal residence, spend some quality time with your tax advisor.

---



### Farr Law Firm since 1924

Since 1924, the Farr Law Firm has held to our history and tradition of dedication to our community while working with clients to resolve disputes, solve complex problems, realize new opportunities, preserve and protect wealth and maximize growth in changing environments.

The Farr Law Firm is honored to be included in the U.S. News – Best Lawyers® 2016 "Best Law Firms" report, receiving a Tier 1 ranking for outstanding work in trusts and estates law in the Fort Myers metro area.

Best Lawyers® BEST LAW FIRMS U.S.News & WORLD REPORT 2016

**Follow us:**

To subscribe to our newsletters, please visit our website.