1031 Exchange FOCUS

SECTION 1031 OF THE INTERNAL REVENUE CODE IS ONE OF THE GREATEST WEALTH BUILDING TOOLS AVAILABLE TO INVESTORS

> Qualified Use and the Homeowners Exemption

Internal Revenue Code Section 1031 allows investors to defer the payment of capital gains taxes when selling investment property.

One strategy taxpayers have used to avoid paying capital gains taxes has been to convert a rental property into a primary residence, and later sell the property in order to take advantage of the Homeowner's Exemption.

The Homeowner's Exemption (Section 121 of the Tax Code) allows a taxpayer to exclude up to $250,000 ($500,000 for married couples) of gain realized on the sale of a primary residence. An example of a common strategy has been:

- Taxpayer acquires rental property for $100,000
- Taxpayer rents the property out for three years
- Taxpayer then removes the tenants and moves into the property as his/her primary residence
- After living in the primary residence for two years, the taxpayer sells the property for $600,000
- Taxpayer (married couple) avoids paying taxes on the entire gain of $500,000.

Unfortunately, The Housing Assistance Act of 2008, signed by President Bush, includes a modification to the Homeowner's Exemption that renders the above strategy less effective. Effective January 1, 2009, the Homeowner's Exemption exclusion will not apply to gain that is allocable to periods of "non-qualified use."

Non-qualified use refers to periods that the property was not used as the taxpayer's primary residence. In our example, the three years (3) the property was rented out is considered non-qualified use, so three fifths (3/5) of the gain is ineligible for tax exclusion.

IMPORTANT NOTES:

Non-qualified use prior to January 1, 2009 is not taken into account. So a property rented from 2006 to 2009, then lived in from 2009 to 2011 would still qualify for the full exclusion.

The allocation rules only apply to periods prior to conversion to a primary. Thus if a property was lived in for 2 years, then rented out for 3 years, and then sold, the taxpayer will still receive the entire exclusion amount.

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