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Tax considerations when converting an investment property to primary residence - by Bill Lopriore

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Bill Lopriore

Since January 1, 2009, federal tax law limits the amount of gain eligible for exclusion from taxation (known as the “Primary Residence Exclusion”) when you sell a house used as a primary residence, if you also used the house for another purpose, such as a rental.

Under Section 121 of the Internal Revenue Code, you can exclude capital gain taxes on up to \$250,000 of gain, or \$500,000 of gain if married and filing jointly, when you sell a house used as a primary residence for any two of the previous five years.

The gain eligible for Primary Residence Exclusion from taxation will be reduced based on a ratio of the number of years the property is used for non-primary residence purposes to the total number of years owned. Periods of use other than as a primary residence occurring prior to January 1, 2009 will not reduce the excludable gain.

Property acquired in a 1031 exchange and then converted to your primary residence must be owned at least five years before being eligible for the 121 exclusion. However, if the property was first used as a primary residence and then converted to investment property, gain may be excluded under Section 121, and then taxes can be deferred under Section 1031 on the remaining gain.

Bill Lopriore is the northeast regional manager and counsel for First American Exchange Company, LLC.

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