# Certified Divorce Lending Professional

## Divorcing Your Mortgage Educational Series

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## Divorce and the 1031 Exchange Option

Real Estate, whether it is the marital home or investment property, is one of the greatest assets owned by married couples. Typically in a divorce situation, the property is sold or retained by one party, and ownership is transferred solely into their name.

When real estate property owned is sold, each party may be subject to capital gains tax. Depending on the value of the property at the time of the sale vs. the initial acquisition cost plus improvements, it may be wise to speak with a financial planner to weigh all options such as a 1031 exchange. (IRC Section 1031 - like-kind exchange)

Per IRS rules, a 1031 like-kind exchange provides an exception that allows you to postpone paying capital gains taxes if you reinvest the proceeds from the sale of an investment property (the “relinquished property”) into a similar property (the “replacement property”) as part of a qualifying like-kind exchange. The seller has 45 days to identify a replacement property and 180 days to close. There are multiple conditions on the investment property that must be met in order to be considered as a potential replacement property, including a suggested two year hold period.

Once the replacement property is held as an investment and the suggested two year hold time is satisfied, the property can then be converted to a primary residence. By converting the investment property to a primary residence, a portion of the recognized gain or tax due when selling may be reduced by electing to use either the individual exclusion of $250,000 or the marital exclusion of $500,000 per the IRS Capital Gains rule Section 121.

EQUAL HOUSING OPPORTUNITY

Divorcing couples who recently acquired an investment rental property in a 1031 exchange may find themselves in a situation where they haven't yet met the suggested two year hold period, and one party may now want to occupy the property as their new primary residence. Provided the divorcing couple can demonstrate their initial intent was to hold the property as an investment property, they may claim that the divorce is an unforeseen circumstance to potentially avoid any penalties associated with initially purchasing the property through a 1031 exchange.

Unforeseen circumstances can also apply to a "mixed-use" property where the taxpayer utilizes a part of the property as their primary residence and the other portion as an investment property, such as a Bed and Breakfast, farm, or a duplex. The portion used as the primary residence is eligible for the Section 121 exclusion while the portion held as an investment property is eligible for Section 1031 tax deferral. To qualify for the Section 121 exclusion, the taxpayer must hold the principal residence for periods totaling two years or more over a five year period. The exclusion is available once every two years. If the taxpayer fails to meet the two year ownership and use requirements, then a prorated fraction of the exclusion may be taken given the unforeseen circumstances of divorce.

**1031 Exchanges Under Tax Reform**

The Tax Cuts and Jobs Act changed many things about divorce planning, and Section 1031 is no exception. Under the Tax Cuts and Jobs Act, IRC Section 1031 now applies only to like-kind exchanges of real property and not to exchanges of personal or intangible property.

"Effective January 1, 2018, exchanges of machinery, equipment, vehicles, artwork, collectibles, patents, and other intellectual property and intangible business assets generally do not qualify for non-recognition of gain or loss as like-kind exchanges. However, certain exchanges of mutual ditch, reservoir or irrigation stock are still eligible for non-recognition of gain or loss as like-kind exchanges."

Mortgage financing requirements for investment properties vary significantly from guidelines when purchasing primary residential property. Please don't hesitate to reach out to me directly for information on purchasing or refinancing investment property or obtaining new financing when converting investment property to a primary residence.

Always work with a Certified Divorce Lending Professional (CDLP) when real estate or mortgage financing is present in divorce.