

CONVERTING A RENTAL TO A RESIDENCE

"MANY TAXPAYERS CAN TAKE ADVANTAGE OF TWO TAX CODE SECTIONS"



Compliments of

Some taxpayers take advantage of exchanges and the tax deferral available under IRC §1031 and later convert their former rental house to a principal residence to qualify for the tax exclusion available under IRC §121.

HOW LONG TO RENT THE §1031 PROPERTY?

Section 1031 of the tax code does not provide a defined "holding period" for investment properties. The time period the property is held is only one factor the IRS may look at to determine the taxpayer's intent to hold for investment. The IRS can examine all the other facts and circumstances that may or may not support the intent to hold for investment.

Some legal and tax advisors recommend that a taxpayer hold a §1031 exchange property for a minimum of at least twelve months. The reason for this is that a holding period of 12 or more months results in the taxpayer reflecting the property as an investment property in two tax filing years. Another perspective is holding the §1031 exchange property for at least two years. In one Private Letter Ruling (PLR 8429039), the IRS stated that a minimum holding period of two years was sufficient. Many legal and tax advisors who believe two years is a conservative holding period, provided no other significant factors to contradict the investment intent.

IRC §121 - PRINCIPAL RESIDENCE EXCLUSION

Exclusion of up to \$250,000 of the capital gain on a principal residence for a single taxpayer and \$500,000 for a married couple filing jointly. The taxpayer must own and use the home as a principal residence 2 of the 5 years prior to the sale.

HOUSING ASSISTANCE ACT OF 2008

As a result of the Housing Assistance Act of 2008, beginning January 1, 2009, the Section 121 exclusion must be allocated between the period the principal residence was used as an investment property and the period of time the residence was used as a principal residence. Any portion of the exclusion amount that is allocable to the period the property is not used as a principal residence is eliminated.

In general, the allocation rules only apply to time periods prior to the conversion into a principal residence and not to time periods after the conversion out of principal residence use. Accordingly, if a single taxpayer converts a principal residence into a rental property and never moves back in, and otherwise meets the two out of five year relinquished under §121, the taxpayer is eligible for the full \$250,000 exclusion when the rental property is sold. This rule only applies to non-qualified use periods within the 5 year lookback period of §121 after the last date the property was used as a principal residence. Therefore, if the taxpayer used the property as a principal residence in year one and year two, then rented the property for years three and four, and then used it as a principal residence in year five, the allocation rules would apply and only three-fifths (3 out of 5 years) of the gain would be eligible for the exclusion under §121. Every taxpayer is urged to seek the advice of a tax advisor to review their specific situation and application of the tax rules.



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