

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.

§1031 AND §121: 5 YEAR HOLDING PERIOD

All principal residence sales occurring after October 22, 2004 are subject to a five year holding period if the principal residence was originally acquired through a tax deferred exchange. Investors who previously acquired their current residence through a §1031 exchange within the past three years will have to wait at least two more years before selling their residence to exclude the gain.

Under this provision, an Exchanger who performs an IRC §1031 tax deferred exchange into a rental house as replacement property and later converts the rental house into the Exchanger's principal residence, is not allowed to exclude gain under the principal residence exclusion rules of IRC §121 unless the sale occurs at least five years after the closing date of the replacement property acquisition.

COST RECOVERY/DEPRECIATION

Capital gain taxes must be paid on the cost recovery ("depreciation") taken after May 6, 1997 (at 25%), but may exclude additional gain on the principal residence, up to the maximum amounts allowed by §121.



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