

CONVERTING A RESIDENCE TO A RENTAL

“REVENUE PROCEDURE 2005-14: APPLYING §1031 AND §121 TO A SALE”



Compliments of

REVENUE PROCEDURE 2005-14

The IRS recently gave guidance on Revenue Procedure 2005-14 on how to report exchanges of property used as a principal residence and for business/investment use in the last five years. A property owner can convert a principal residence to a rental property and later sell it and benefit from both IRC §121 (principal residence tax exclusion rules) and IRC §1031 (investment property tax deferred exchange rules). Property owners must comply with all the rules in both sections to qualify.

APPLICATION OF §121 AND §1031

If a property owner has owned and lived in a principal residence for at least 2 out of the last 5 years preceding the sale of the principal residence, \$250,000 if filing as a single (\$500,000 on a joint return) of the gain from the sale, except for any depreciation taken on the property since May 6, 1997, can be excluded. IRC §121 does not require the owner to live in the property at the time of the closing to qualify for the gain exclusion. A principal residence does not qualify if it was purchased in a §1031 exchange within the previous five years.

In essence, the Treasury has declared that if an owner lives in the residence long enough to meet the principal residence requirements, they may then convert the house into a property “held for investment” which can qualify for a §1031 exchange. (Note: Although there is no defined “holding period” to be considered “held for investment,” many tax/legal advisors believe 1-2 years is sufficient barring any factors which contradict an investment intent.) The property owner can perform an IRC §1031 exchange and still be eligible for gain exclusion under IRC §121, even if it is presently being used as a rental.

When the owner sells the home as an investment property, they must still meet all the necessary requirements for a §1031 exchange. This includes hiring a Qualified Intermediary prior to closing on the relinquished property and adhering to all the time requirements of an exchange, such as identifying the replacement property within 45 calendar days from the sale date and purchasing all replacement properties within 180 days, or the owner’s tax filing date, whichever is earlier.

DEPRECIATION

The property owner can exclude gain up to \$250,000 (filing as a single) or \$500,000 (filing jointly) under IRC §121 except for any depreciation taken on the property after May 6, 1997. Realized gain is first excluded under IRC §121 and then is eligible for deferral under IRC §1031.

The revenue procedure provides six examples that include illustrations of the treatment of depreciation and boot in which both the benefit of §121 exclusion and §1031 deferral could be used. Please visit the “Tax Code/Legal References” section at apiexchange.com to read the full text of Revenue Procedure 2005-14.



ASSET PRESERVATION
INCORPORATED

National IRC §1031 “Qualified Intermediary”

National Headquarters

800-282-1031

Eastern Region Office

866-394-1031

apiexchange.com

info@apiexchange.com

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