Converting Investment Property to Primary Residence

Law Affects Exclusion

Since January 1, 2009, federal tax law limits the amount of gain that can be excluded when you sell a house used as a primary residence if you also used the house for another purpose, such as a rental.

Under the rules of Section 121 of the Internal Revenue Code, you will not owe capital gain taxes on up to $250,000 of gain, or $500,000 of gain if you are married and filing jointly, when you sell a house used as a primary residence for two of the previous five years. The two year period does not need to be consecutive to qualify for the exclusion.

The amount of gain that you can exclude will be reduced to the extent that the house was used for something other than a primary residence during the period of ownership, however. The exclusion is reduced pro rata by comparing the number of years the property is used for non-primary residence purposes to the total number of years the property is owned by the taxpayer.

For example, a married couple uses a tax deferred exchange under Section 1031 to acquire a house used as a rental in 2009. The couple rents the house for three years, and then moves into it and uses it as their primary residence for the next three years. The couple decides to sell the property at the end of year 6, netting a total gain of $800,000. Under the new rules, instead of being able to exclude $500,000, the couple will not be able to exclude some of the gain based on how many years they rented the house. Since they rented it for three years out of six, 50% of the gain, or $400,000, will not be able to be excluded. Because of this new limitation, the couple will be able to exclude $400,000 of the gain rather than $500,000.

Exceptions

There are several exceptions to this restriction that will be useful to know. First, any periods where the house is used other than as a primary residence that occurs prior to January 1, 2009 will not reduce the excludable gain. Using the example provided above, if the three year rental period occurs prior to January 1, 2009, the exclusion would not be reduced and the couple would be able to exclude the full $500,000.

Another important exception is that property that is first used as a primary residence and later converted to investment property will not be affected by this new law. For example, you own and live in a house for 18 years. Subsequently, you move out and rent the house for two years before selling it. Because your investment use occurred after the last day of use as a primary residence, all of the gain accumulated over your 20 year ownership of the property can be excluded, up to $250,000, or $500,000 if you are married and filing jointly.

Continued.

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Taxpayers who serve on "qualified official extended duty" or are temporarily absent due to changes of employment, health conditions or other unforeseen circumstances should have their tax advisors review the law, as it has some limited exceptions that will benefit them.

Combining Exclusion with 1031 Exchange

As required by an earlier change to Section 121, if you acquire a property in a 1031 exchange and then convert it to your primary residence, you must own the property at least five years before being eligible for the 121 exclusion.

Fortunately, the rules are still favorable if you are looking to combine Section 1031 with Section 121 to both exclude and defer tax when the property starts out as a primary residence and then is converted into an investment property. Provided the personal use occurs first, you can exclude gain under Section 121, and then defer tax on the remaining gain.

The Internal Revenue Code still provides investors with good options for exclusion of gain and tax deferral. The rules can be complicated, but with the right planning taxpayers can still make the most of their real estate investments.

References: *Internal Revenue Code §121; Housing Assistance Tax Act of 2008 (H.R. 3221).*

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