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Converting an Investment Rental into a Principal Residence

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Many of our clients strategize to exchange investment rental property into another new investment rental property, in a great location like the Outer Banks, which they will eventually convert into a primary residence. This powerful tax strategy takes planning but essentially converts investment property into a future retirement property. Section 121 of the Internal Revenue Code defines the tax treatment of our primary residences when we sell them. Married couples filing jointly can exclude up to $500,000 of gain when they sell their principal residence. Single taxpayers can exclude up to $250,000 of their gain. To qualify for the exclusion, you must have owned and used the home as a principal residence for an aggregate of two years out of the five years before the sale. You can only have one primary residence at a time; all other properties you own are either second homes or investments. A full explanation of the exclusions can be found in IRS Publication 523, Selling Your Home.

The strategy to exchange an investment rental for a new investment rental in a location where we may wish to retire takes some planning but will maximize your tax savings. When you exchange your current investment rental property into a new investment rental property, you defer the tax you would normally have to pay on the gain. This is reflected in the lower basis assigned to your new replacement property.

When you sell your current principal residence, you exclude the gain up to the Section 121 limits. Then, after you convert your replacement property into your new principal residence, you become eligible once again for exclusion of up to $250,000/$500,000 of gain after you have owned the replacement property for five years and used it as a principal residence for two years. The five-year ownership on a principal residence only applies to properties that have come to you from an exchange. Tax will be due on gains above the Section 121 limits and any depreciation taken after May 6, 1997.

If you just acquired a property by doing a like-kind exchange, you must hold the new property as an investment, rental, or business property. No one can tell you how long the exchange replacement property must be held in investment status before you convert it to personal use, but most tax experts recommend not less than one year. The IRS issued Revenue Procedure

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2008-16 which defines a safe harbor and includes a two-year holding period of limited personal use and a rental period if you want to be safe.

The current issue is that effective January 1, 2009, the IRS Section 121 was changed. Before the President signed H.R. 3221, the Housing Assistance Tax Act of 2008, on July 30, 2008, a revenue-raising provision first promoted by Representative Charlie Rangel (D, N.Y.) was included by the conference committee as Section 3092 of the bill. This provision is an amendment to Section 121 and has a major impact on small landlords and taxpayers who were planning to convert their rental or second home to a principal residence and then exclude any gain from their income when they sell the property.

The term Period of Non-Qualified Use referenced in the amendment is very important and means any period during which the property is not used as the principal residence of the taxpayer, the taxpayer's spouse, or a former spouse. Importantly, the period before January 1, 2009, is excluded. In addition, subsection (4)(C)(ii) of the amendment provides additional exceptions to Period of Non-Qualified Use. These exceptions are (1) any portion of the five-year period (as defined in Section 121(a)) which is after the last date that such property is used as the principal residence of the taxpayer or spouse, (2) any period not exceeding 10 years during which the military or foreign service taxpayer, or spouse, is serving on qualified official extended duty as already defined, and (3) any other period of temporary absence (not to exceed a total of two years) due to change of employment, health conditions, or such other unforeseen circumstances as may be specified by the HUD Secretary.

The amendment states "gain shall be allocated to periods of non-qualified use based on the ratio which (i) the aggregate periods of non-qualified use during the period such property was owned by the taxpayer, bears to (ii) the period such property was owned by the taxpayer."

How does this affect your second home planning? Suppose the married taxpayer exchanged into an investment property and rented it for four years, then moved into it and lived in it for two years. The taxpayer then sold the residence and realized

$300,000 of gain. Under prior law, the taxpayer would be eligible for the full exclusion and would pay no tax.

Under the new law, the exclusion will have to be prorated as follows: four-sixths (4 out of 6 years) of the gain, or $200,000, would be taxable and thus would be ineligible for the exclusion. Two-sixths (2 out of 6 years) of the gain, or only $100,000, would be eligible for the exclusion.

Importantly, non-qualified use prior to January 1, 2009, is not taken into account in the allocation for the non-qualified use period but is taken account for the ownership period. Thus, suppose the taxpayer had exchanged into the property in 2007, and rented it for three years until 2010,and then converted the property into a primary residence. If the taxpayer sold the residence in 2013, after three years of primary residential use, only one year of rental, 2009, would be considered in the allocation for the non-qualified use. Thus, only one-sixth (1 out of 6 years) of the gain would be ineligible for the exclusion.

In general, the allocation rules only apply to time periods prior to the conversion into a principal residence and not to all time periods after the conversion out of personal residence use. Thus, if a taxpayer converts a primary residence to a rental and never moves back in but otherwise meets the two-out-of-five year test under Section 121, the taxpayer is eligible for the full exclusion when the rental is sold. This rule only applies to non-qualified use periods within the five-year look-back period of Section 121(a) after the last date the property is used as a principal residence.

This great tax strategy is still available, but Congress has created new rules, so it is important taxpayers get good advice before making any moves.

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