Personal Residence to Rental— "The Super Tax Break"

Did you know that you can avoid paying tax on more than $500,000 of gain on your home? Many people are aware of the advantages of Internal Revenue Code Section 121, which allows a married couple to exclude up to $500,000 of gain on the sale of their personal residence ($250,000 for a single Taxpayer). Although this amount of gain is generous in most areas of the country, in California and a few other states, many people expect to receive more than $500,000 of profit when they sell their home.

What is much less understood in the real estate world is that a homeowner can avoid paying all of the tax on their home by converting it to a rental. Once the home is converted to a rental, the owners can sell it and use both the Section 121 exclusion of gain and the Section 1031 deferral of gain provisions to exclude some of the gain and defer paying tax on the rest.

For example:
John and Mary Smith have lived in their home for twenty years. They acquired it for $100,000 and it is now worth $1 million, so if sold, they would have $900,000 of gain. If they sell it without converting it to a rental, they would be able to exclude $500,000 of gain but would have to pay state and federal capital gains tax on the additional $400,000 of gain.

John and Mary decide, however, to convert their property to a rental. After renting it for a year or two, they sell it for $1 million. Since they used the home as their personal residence at least two of the past five years, they are able to exclude $500,000 of the gain. They can then use the remaining funds to acquire replacement investment property and defer paying tax on the balance of the gain.

In order to completely defer the remaining gain, the traditional rule is that the investor must acquire property with a fair market value equal to or greater than the relinquished property, and must invest all of the equity from the relinquished property into the replacement property. When gain has been excluded under Section 121, the amount of value and equity required is reduced by the amount of gain that was excluded.

To be certain that they will defer all of the remaining gain, the Smiths should consult with their tax advisor before setting up the exchange. Although the new property must be investment property, the Smiths can decide later to move into it, and if they live in it a minimum of two years and own it for at least five years, they can exclude up to $500,000 of gain on the sale of that property.

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Of course, investors need to comply with all of the rules of Sections 121 and 1031 in order for this to work. The IRS recently published Revenue Procedure 2005-14, which explains how the two statutes may be combined for one property. This includes not only the situation mentioned above, but also a sale of a personal residence with a home office or separate guest house that is rented.

Some of the requirements to keep in mind are:

- To take advantage of the $500,000 exclusion ($250,000 for single Taxpayers), you must own and live in your home at least two of the past five years;
- You can only take advantage of the section 121 exclusion once every two years;
- Section 121 doesn't allow you to exclude any gain attributable to depreciation deductions taken since May 6, 1997, but that gain can be deferred under Section 1031; and
- To take advantage of the deferral of gain under Section 1031, all or a part of the property you sell and the property you acquire must at the time of sale be used in connection with your business or held for investment.

This article discusses some general concepts, but you should consult with your tax advisor to plan your particular situation. You should also contact First American Exchange Company to set up your tax deferred exchange.

References: Revenue Procedure 2005-14; Internal Revenue Code Section 121.

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