

## CONGRESS TAKETH AWAY!

### *The Housing and Economic Recovery ACT of 2008 Effects Changes to Section 121*

Taxpayers who own a second home and want to defer the capital gain on sale have used one of two strategies to achieve tax relief. The property can be converted to rental property for a minimum of two years prior to sale and structured as a Section 1031 Exchange using a Qualified intermediary with the acquisition of new Replacement property that is also rented for the first two years after acquisition. The second method is to simply move into the second home and declare it as your primary residence for a minimum of two years and when sold use the Provisions of Section 121, Sale of Primary Residence, to exclude \$250,000 of the gain per taxpayer or \$500,000 for a married couple filing jointly.

The first strategy allows taxpayers with the ability to walk away from the deferred tax indefinitely by exchanging again and again. The second provided an outright exclusion from the capital gain tax if it did not exceed the limitations. Since the primary residence exclusion can be used every two years, a planning opportunity for full tax escape has benefited thousands of taxpayers.

The Housing & Economic Recovery Act of 2008, signed into law on July 30, 2008, contains a restriction on the practice of converting your second home to your primary residence. It requires that the exclusion be prorated based on the time the property was used as a second home. The portion of the profit that will be taxed is based on the ratio of the time after 2008 that the home was used as a second residence or rented out to the total time that the taxpayer owned the property. The balance of the gain will remain eligible for the Section 121 Exclusion.

To illustrate the point; a second home is owned for five years and converted to a primary residence after 2008 for two years prior to sale. At sale, the taxpayer will pay capital gain tax on 2/7 or 28.57% of the gain, the balance will be excluded up to the Section 121 limitations. The longer a property is owned, the lower the ultimate tax will be.

## EXAMPLE

"Congress did restrict a break for turning a second home into a main home: Some of the gain will be ineligible for the home-sale exclusion if the house is converted to personal use after 2008 and is later sold. The portion of the profit that's taxed is based on the ratio of the time after 2008 when the house was used as a second residence **or rented out** (emphasis added) to the total time that the seller owned the house. The rest of the gain remains eligible for the home-sale exclusion of \$500,000."

*Source – Kiplinger Tax Letter Volume 83 #15 July 25, 2008*

Taxpayer's original cost in his Relinquished Property is \$100K, with \$50K of depreciation already taken.

Sale price is \$400K, no debt, QI receives \$400K (neglect expenses).

Replacement Property is a Single Family House (SFH) costing \$400K on 1/1/09; adjusted basis is \$50K.

Owner enters the house as his home on 1/1/11, and sells it on 1/1/14 for \$600K. During the rental period he claimed \$10K more depreciation. Adjusted basis on 1/1/11 is \$40K.

Indicated gain at time of sale is \$560K. Under the OLD RULE, this married taxpayer would pay tax on \$60K, and exclude \$500K of the gain. Under the NEW RULE, this married taxpayer must make the following calculation:

Owned 5 years (denominator), rented for 2 years (numerator);  $2/5 \times \$560K$  gain is \$224K recognized, balance excluded.

The incentive is to reduce this fraction by either owning the property longer (increases denominator) or renting it out for less time (reduces numerator, but flies in the face of Rev. Proc. 2008-16).

It seems that the days of simply buying an SFH (or a series of SFH's) with your exchange dollars, and later converting it (them) to your principle residence(s), selling and eliminating \$500K at a time are over.

## NEW SECTION 121 RULES

UNQUALIFIED TIME % THAT APPLY TO RECOGNIZED GAIN ON THE SALE OF A PREVIOUS SECOND/RENTAL HOME ON/AFTER 1/1/09

ROW>> Months & years of total ownership    COLUMN>> Months & years of rental and/or second home use    ENTRY>> This C.G.% is unqualified/taxed.

Owned:	6	12	18	24	30	3	4	5	6	7	8	9	10	11	12
Rent/2nd															
0	100%	100%	100%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%
6	100%	100%	100%	100%	20%	17%	13%	10%	8%	7%	6%	6%	5%	5%	4%
12	N/A	100%	100%	100%	100%	33%	25%	20%	17%	14%	13%	11%	10%	9%	8%
18	N/A	N/A	100%	100%	100%	100%	38%	30%	25%	21%	19%	17%	15%	14%	13%
<b>24</b>	N/A	N/A	N/A	100%	100%	100%	50%	<b>40%</b>	<b>33%</b>	<b>29%</b>	<b>25%</b>	<b>22%</b>	<b>20%</b>	<b>18%</b>	<b>17%</b>
30	N/A	N/A	N/A	N/A	100%	100%	100%	50%	42%	36%	31%	28%	25%	23%	21%
3	N/A	N/A	N/A	N/A	N/A	100%	100%	60%	50%	43%	38%	33%	30%	27%	25%
4	N/A	N/A	N/A	N/A	N/A	N/A	100%	100%	67%	57%	50%	44%	40%	36%	33%
5	N/A	N/A	N/A	N/A	N/A	N/A	N/A	100%	100%	71%	63%	56%	50%	45%	42%
6	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	100%	100%	75%	67%	60%	55%	50%
7	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	100%	100%	78%	70%	64%	58%
8	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	100%	100%	80%	73%	67%
9	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	100%	100%	82%	75%
10	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	100%	100%	83%
11	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	100%	100%

**BOLD>> THIS IS THE MINIMUM TIME TO SATISFY BOTH SECTION 1031 AND SECTION 121; THE LONGER THE PROPERTY IS OWNED THE BETTER**

George Foss 9/02/08