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Valuable Information for Real Estate Professionals and their Clients

Housing Assistance Tax Act of 2008

When Congress passed the Housing Assistance Tax Act of 2008, their goal was to help individuals in danger of losing their homes to foreclosure. However the bill also included a modification to the Section 121 exclusion of gain on the sale of a primary residence.

SECTION 121 PRIMARY RESIDENCE EXCLUSION

Under Section 121, a taxpayer can exclude up to $250,000 ($500,000 for married couples) of gain from a sale of a primary residence if they have owned and occupied the residence for two years during the five year period prior to the date of sale. Investment property owners would take advantage of this exclusion by utilizing the following strategy.

Initially the taxpayer would sell investment property and defer tax by utilizing a 1031 exchange into a rental house. After a period of time, generally two years, the taxpayer would move into the house and it would convert to a personal residence, assume two additional years. Even though the taxpayer met the "two out of five year" requirement, a special rule pertains to individuals who have acquired the property through a 1031 exchange. An Exchangor must have five years of total ownership, as well as meet the "two out of five year" requirement to be eligible for the §121 exclusion.

MODIFICATION TO PRIMARY RESIDENCE EXCLUSION

Effective January 1, 2009, the exclusion will not apply to gain from the sale of the residence that is allocated to periods of "non-qualified use." Non-qualified use refers to periods that the property is not used as a primary residence.

AFFECT ON §1031 EXCHANGE PLANNING

How does this affect §1031 planning? Suppose a single taxpayer exchanges into a rental property and rents it for four years. Then the taxpayer moves into this former rental property and lives in it for two years as a primary residence. The taxpayer then sells the property and realizes $180,000 of gain. Under the prior law, the single taxpayer would be eligible for the full $250,00 exclusion and would not pay any taxes on the sale. Under the new law, the exclusion would have to be prorated as follows:

- Four-sixths (4 out of 6 years) of the gain, or $120,000, would be ineligible for the $250,000 exclusion
- Two-sixths (2 out of 6 years) of the gain, or $60,000, would be eligible for the $250,000 exclusion

Non-qualified use prior to January 1, 2009 is not taken into account when computing the gain that is ineligible for the exclusion. Suppose the taxpayer had exchanged into the property in 2007, and rented for 3 years until 2010 prior to the conversion into a primary residence. If the taxpayer sold the residence in 2013, after 3 years as a primary residence, only the 2009 rental period would be considered in the allocation for non-qualified use. Therefore only one-sixth (1 out of 6 years) of the gain would be ineligible for the §121 exclusion.

In general, the new law only covers those situations where the investment use falls before the primary residence period. Investment use applies to use as a second home, as well as a rental property. Good planning can minimize the effects of the modification to §121. Contact our office for further questions or to discuss your situation in detail!