REPRINTED FROM THE
TUESDAY, SEPTEMBER 16, 2008 ny NEW YORK
Real Estate Journal
COVERING ALL OF LONG ISLAND, NEW YORK CITY AND UPSTATE NEW YORK

How the Housing Assistance Act of 2008 impacts investors

pm Pamela Michaels

Asset Preservation

For years, taxpayers had been able to acquire residential property in an IRC §1031 exchange, rent it out for a couple of years and then decide to convert the property to a primary residence without losing any of the tax benefits of Internal Revenue Code (IRC) §121, which allows taxpayers to exclude from gain $250,000 or $500,000 for married couples filing jointly on the sale of a principal residence provided the taxpayer has owned and used the residence as the taxpayer's residence for any two years during the five year period ending on the date the residence is sold. The ability to take advantage of the benefit was limited in 2004 where the property has originally been acquired in a §1031 exchange. At that time, the IRC was amended to limit the ability of taxpayers to take any IRC §121 exclusion if the property had originally been acquired in an IRC §1031 exchange and thereafter converted to a principal residence and sold by the taxpayer prior to the taxpayer having owned the property for five years. This meant that if a taxpayer acquired property in a §1031 exchange, rented it for two years, then used it as a principal residence for two years and thereafter sold it in year five, the taxpayer would be denied the ability to exclude any portion of the gain incurred under IRC §121. As §1031 would not be available to the taxpayer in such circumstances, this modification to the law meant that the entire gain on the property would be taxable.

In New York City and other areas of the Northeast, where appreciation in the late '90s through 2006 was significant, the exclusion granted to taxpayers under §121 generally was only sufficient to cover part of the gain on the sale of a primary residence where the taxpayer had owned the property for a number of years. Thus, converting to a rental prior to sale to piggyback the benefits of §1031 with §121 was a tool used by some to maximize their tax savings and preserve their equity. Prior to the Housing Assistance Tax Act of 2008, a taxpayer employing both strategies and selling an investment property that had been a principal residence two of the last five years could pocket the entire $250,000/$500,000 exclusion tax free and reinvest the remainder of one's proceeds in replacement property in a §1031 exchange and pay no tax at all on the sale.

The Housing Assistance Tax Act of 2008, signed by President Bush on July 30, amends §121 again in a way less favorable to taxpayers. The law will further limit the ability of a taxpayer under some circumstances to take advantage of the full $250,000/$500,000 exclusion on the sale of a principal residence if the property was originally acquired in a §1031 exchange, even if the taxpayer has owned the property for a total of five years prior to sale and used it for two of the last five years as a principal residence. As of January 1, 2009, any applicable exclusion must be allocated between the period the principal residence was used as an investment property or second home, and the period of time the residence was used as the taxpayer's principal residence. Any portion of the exclusion amount that is allocable to the period the property is not used as the taxpayer's principal residence is eliminated.

How does this change affect §1031 tax deferred exchange planning? Suppose a single taxpayer exchanges into a rental property which is rented for four years, and then moves into this former property and lives in it for two years as a principal residence. The taxpayer then sells the principal residence and realizes $300,000 of gain. Under prior tax law, the taxpayer would be eligible for the full $250,000 exclusion and would pay tax on the $50,000 remainder. Under the new law, the exclusion would have to be prorated as follows (Note: This example does not take into account deprecation taken after May 1997, which is taxable at 25%):

- Two-thirds (four out of six years) of the gain, or $200,000, would be ineligible for the $250,000 exclusion;
- One-third (two out of six years) of the gain, or $100,000, is eligible for the exclusion. [This example was changed to show that the allocation formula takes into account years before the five year lookback period in §121(a).]

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 into account for the ownership period).

Suppose the taxpayer had exchanged into the property in 2007, and rented for 3 years until 2010 prior to the conversion to a principal residence. If the taxpayer sold the residence in 2013, after three years as a principal residence, only the 2009 rental period 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 §121 tax exclusion.

Notably, the allocation rules generally apply only to time periods prior to the conversion into a principal residence and not to time periods after the conversion out of principal residence use. Thus, if at the time of the sale of the property it is a rental property but has for 2 of the last 5 years been a principal residence, the applicable exclusion need not be allocated. Accordingly, if a single taxpayer converts a principal residence into a rental property and never moves back in, and otherwise meets the two out of five year relinquished under §121, the taxpayer is eligible for the full $250,000 exclusion when the rental property is sold. This rule only applies to non-qualified use periods within the 5 year lookback period of §121 after the last date the property was used as a principal residence. Therefore, if the taxpayer used the property as a principal residence in year one and year two, then rented the property for years three and four, and then used it as a principal residence in year five, the allocation rules would apply and only three-fifths (3 out of 5 years) of the gain would be eligible for the exclusion under §121. A simple way to determine if the allocation rules of the Housing Act of 2008 may apply to a transaction is to determine if the property is a principal residence at the time of sale. If not, then the allocation rules do not generally apply.

As a "Qualified Intermediary" as defined in the Section 1031 regulations, Asset Preservation, Inc. is not able to provide legal or tax advice. Accordingly, you should review the details of your specific transaction with your own legal or tax advisor.

Pamela Michaels is an attorney and vice president of Asset Preservation, Inc., Manhattan, N.Y.