

HOUSING ASSISTANCE ACT OF 2008

"REDUCED §121 GAIN EXCLUSION IN SOME CIRCUMSTANCES"



Compliments of

Internal Revenue Code (IRC) Section 121 permits a taxpayer to exclude gain in the amount of \$250,000 or \$500,000 for married couples filing jointly on the sale of the a principal residence. A residence is a principal residence if the taxpayer has owned and used the residence as the taxpayer's residence for any two (2) years during the five year period ending on the date the residence is sold. The Housing Assistance Tax Act of 2008, signed by President Bush on July 30, 2008, amends §121 and may reduce the exclusion available to taxpayers who initially acquired the principal residence in a §1031 tax deferred exchange or used the property as a rental property before converting the rental property into a principal residence. As of January 1, 2009, the 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 (4) years, and then moves into this former property and lives in it for two (2) 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 depreciation taken after May 1997, which is taxable at 25%).

- Two-thirds (4 out of 6 years) of the gain, or \$200,000, would be ineligible for the \$250,000 exclusion.
- One-third (2 out of 6 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 5 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.

In general, the allocation rules only apply to time periods prior to the conversion into a principal residence and not to time periods after the conversion out of principal residence use. 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.



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