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BULLETIN
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New Rules for Taxing Gain: 2008 Housing and Economic Recovery Act (HERA) Exclusion Changes

By: Carol-Ann Simon, Perkins & Company, P.C.

The 2008 Housing and Economic Recovery Act (HERA), H.R. 3221, included a provision that modifies the application of the $250,000/ $500,000 exclusion, but ONLY in situations in which an individual who owns a second home or rental home converts it to use it as his/her principal residence. When the former second/ rental home is sold, some portion of the gain may be taxable, even when the owner has lived in the home for the required two of the previous five years. Affected second/rental homes are any residences the individual owns that are not used as a principal residence.

A principal residence will be eligible for the full $250,000/$500,000 exclusion of gain on sale only when the property is used solely as the owner's principal residence. (As in the past, gains above the exclusion amount remain taxable.) The new rule is a so-called "use" test. It requires the owner of a second home or rental home that becomes a principal residence to compute the exclusion amount and any taxable gain based on the use of the property.

Starting January 1, 2009, individuals who convert a second or rental home to a principal residence and then later sell that property will use a fraction to determine the taxable portion of any gain and the amount eligible for the exclusion. The numerator of the fraction will be the amount of time, starting January 1, 2009, that the property is used as a rental or investment property or as a second home. The denominator of the fraction will be the total number of years of ownership, dating from the original purchase date. No appraisals will be required and people who have held properties for a long time will not suffer any disadvantage.

The examples below illustrate the application of this new rule.

Example 1: Post-2008 Purchase and Sale

Charlie, whose tax filing status is single, bought a vacation property costing $400,000 on March 1, 2009. On March 1, 2012, she converts the property to her principal residence. On March 1, 2014, she sells the property for $700,000, realizing a gain of $300,000. Thus, she has owned the property for 5 years and used it as a principal residence for 2 years. On these facts, 40% of the gain (2 / 5) is eligible for the $250,000/$500,000 exclusion (2 years use as a principal residence divided by 5 years of ownership). The remainder of the gain (60%: 3 years as non-principal residence / 5 years of ownership) will be taxed at the capital gains rate that applies in the year of sale.

Of the total $300,000 gain, $180,000 ($300,000 x .60) will be treated as a capital gain. If the capital gains rate in 2014 is still 15%, the total tax would be $27,000 ($180,000 x .15). Since the remaining $120,000 of gain is less than $250,000, $120,000 is eligible for the exclusion. Charlie's best tax-reduction strategy would be to increase the number of years she uses the home as her principal residence.

Example 2: Pre-2009 Purchase and Post-2008 Sale

John and Sara, who file a joint tax return, bought a vacation property in 1985 for $100,000. During the years they have owned it, they have used it solely as a vacation home. (In some years they rented it on a short-term basis, but never for a period long enough to require them to recognize the rental income or to require depreciation deductions.) On January 1, 2011, they move into the home and begin to use it as their principal residence. During the time they have owned it, they have added $125,000 in improvements. The community where it is located has become a major resort, so they have enjoyed significant appreciation, as well.

In 2020, they sell the home for $1 million. Their taxable gain and exclusion are as follows:

Total amount of gain:	$775,000 ($1 million selling price minus original cost [$100,000] and improvements [$125,000]).
Taxable post-2008 gain:	This is the number of years AFTER 2008 that the property is NOT used as a principal residence, divided by the total period of ownership:

Number of non-residential years:		2 (2009, 2010)
Number of years of ownership:		35 (1985 – 2020)
Taxable Gain:		2/35 x $775,000 = $44,285
Tax on non-residential use:		$6,643 (assuming 15% capital gains rate)
Exclusion:	Remaining gain:	$730,715 ($775,000 - $44,285)
	Excludable amount:	$500,000
Remaining taxable amount:		$230,715 ($730,715 - $500,000)
	Tax on excess over exclusion:	$34,607 (assuming 15% capital gains rate)

Example 3: Pre-2009 Conversion to Principal Residence

Fred and Ethel bought a townhouse that they've used solely as a rental property since 1989. They decided to simplify by selling their big house in the suburbs and moving into the townhouse. They moved into it on April 15, 2008. In April 2019, they sell the townhouse. They have a very low basis in the townhouse because it was used as a rental property for 19 years (1989 – 2008), leaving them with a gain of $600,000.

When they sell the townhouse, they will be eligible for the $500,000 exclusion because the property was their principal residence on January 1, 2009. In this case, they will pay tax on the $100,000 excess over $500,000 ($600,000 gain minus $500,000 exclusion) at the capital gains rate in effect for 2019. In addition, they will be liable for the depreciation recapture taxes for the years that the property was used as a rental property. The depreciation recapture tax will be imposed at the rate in effect for 2019. (That rate is presently 25%.)

Observations:

- The policy goal of the change was to look to the use of the property after January 1, 2009. During periods the property is used as a second/rental home, gain on sale will receive capital gains treatment. During the period it is used as a principal residence, gain on sale will receive principal residence exclusion benefits.
- After 2008, when a second/rental home is converted to a principal residence, the rule of thumb will be that the longer the period of use as a principal residence, the greater the amount of the excludable gain.
- This policy change can affect temporarily relocated expatriates who rent out their homes while abroad. This new law could expose them to capital gain tax on their homes long after their assignments end.

This bulletin is a summary and is not intended as tax or legal advice. You should consult with your tax advisor to obtain specific advice with respect to your fact pattern.

Based on the most recent "best practice" standards for tax advisors issued by the Treasury Department, commonly referred to as Circular 230, we wish to advise you that this bulletin has not been prepared to be used, and cannot be used, to provide assurance that penalties which may be assessed by the IRS or other taxing authority (including specifically section 6662 understatement penalties) will not be upheld.

+ 1211 SW Fifth Avenue, Suite 1000
+ Portland, Oregon 97204-3710

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