Gain on Sale of Primary Residence: New Tax Implications

By Russell, Richard L,Clovey, Robert

Publication: The CPA Journal

Date: Sunday, February 1 2009

On July 30, 2008, President George W. Bush signed the Housing Assistance Tax Act of 2008 (H.R. 3221). The act includes $15.1 billion in tax incentives in an effort to help rejuvenate the slumping U.S. economy. In addition to the incentives, the act contains a number of provisions designed to make the bill revenue-neutral. While tax preparers should become familiar with all provisions of the bill, professionals preparing income tax returns and taxpayers contemplating the sale of a personal residence should pay particular attention to section 3092, the "Reduced Home Sale Exclusion," under IRC section 121.

This provision is expected to raise an estimated $1,394 billion in tax revenue over 10 years. This would be accomplished by closing a loophole whereby taxpayers who sold residential rental properties or vacation homes at a gain took advantage of the exclusion available under IRC 121. With proper planning, taxpayers owning rental property or vacation homes have been able to sell those properties at a gain, with significantly reduced tax consequences-or none at all-every two years.

The new provision provides that certain uses of these properties will be classified as "disqualified use" for the purposes of the IRC section 121 exclusion. This disqualified use will result in the inclusion in gross income of some of the gain that was previously excluded from gross income. In other words, sales of properties with disqualified use can now trigger tax consequences on part of the gain that was formerly excluded from gross income. While the law restricts the ability of taxpayers to exclude gains under section 121 on properties with disqualified use, it provides an exception that presents homeowners with limited tax planning opportunities.

The following is a comparison of the effect of sales using the general rule of IRC section 121 before and after the Housing Assistance Tax Act took effect. There are three exceptions to the disqualified use of property sold after January 1, 2009, and the sales that straddle the effective date of the new law require special consideration. Finally, there are certain tax strategies for taxpayers owning these properties that tax advisors should consider.

Pre-2009 Application of IRC 121

Regarding gains from the sale of principal residences, IRC section 121(a) specifically provides that gross income shall not include gain from the sale or exchange of property, if during the five-year period ending on the date of the sale or exchange, such property has been owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating two years or more. In addition to satisfying this ownership-and-use test, taxpayers may not use this exclusion more than once in two years.

There are three exceptions (change in place of employment, change in health, and other unforeseen circumstances) to the twoyear ownership-and-use requirement and the once-in-two-years use of the exclusion. These exceptions have not been affected by the new law's changes to IRC section 121. Under IRC 121, single taxpayers meeting these conditions are allowed to exclude a maximum of $250,000 of realized gain, and married couples filing jointly can exclude up to $500,000.

Under prior law, taxpayers planning to sell vacation homes or rental properties that have appreciated in value could simply move into the property for at least two years, satisfy the above ownership-and-use test, and be allowed to exclude the gain permitted under FRC 121, as long as the exclusion was not utilized within the past two years.

Example 1: John, a single taxpayer, sold his personal residence on January 1, 2008. He had purchased it on January 1, 2003, and used it as a rental property for three years, until January 1, 2006. On January 1, 2006, John moved into the property and used it as his personal residence for two years. Under the previous application of IRC section 121, John could exclude realized gains of up to $250,000 on the property. During the five-year period ending on the date of sale (January 2, 2003, to January 1, 2008), John owned and used the property as his principal residence for an aggregate period of at least two years. The only other requirement under prior law was that John should not have used the IRC section 121 exclusion in the previous two years.

Example 2: The Rodgers, a married couple, owned a residence for the past 10 years. For the first eight years, they used the residence as rental property; they used it as their primary residence for the last two years. They then sold the home at the end of the 10th year. In 2008, the Rodgers can claim the full $500,000 exclusion. The requirements are that in a five-year lookback period, the property must have been owned and used as the taxpayer's principal residence for at least two years and that the IRC section 121 exclusion had not been utilized within the past two years. The Rodgers qualified for the full exclusion, even though the residence was only used as their primary residence 20% of the time that they owned it.

As shown in examples 1 and 2, in the application of IRC section 121 under prior law, taxpayers had to answer two questions to determine whether they qualified for the gain exclusion of up to $250,000 or $500,000: 1) Did the taxpayers own and use the property as their principal residence for two of the past five years? 2) If the answer to this was yes, had they taken advantage of this exclusion within the last two years? If the answer to this question was no, then the taxpayer could use the section 121 exclusion.

Post-2008 Application of IRC 121

The Housing Assistance Tax Act of 2008 made significant changes to IRC section 121 that are effective for transactions

occurring after December 31, 2008. The criteria to determine whether taxpayers are eligible to use the IRC section 121 exclusion are still the same: the ownership-and-use test and the once-in-two-years limitation. The new law does, however, significantly affect the amount of gain eligible for the exclusion. IRC section 121(b) (4) (5) now provides that if a taxpayer sells property at a gain and there are periods of qualified and unqualified use, that gain has to be allocated. The portion allocated to unqualified use is no longer eligible for exclusion under IRC section 121, and must be included in gross income. The allocation to unqualified use is based on a ratio whereby the period of ownership (not necessarily five years) is the denominator and the period of unqualified use is the numerator.

Unqualified use is any period or portion thereof after January 1, 2009, when the taxpayer or the taxpayer's spouse or former spouse does not use the property as his primary residence.

The effect is that taxpayers selling residences at gains and with period(s) of unqualified use are no longer allowed the full exclusion amounts of $250,000 and $500,000.

Example 3: Assume the same facts as in example 1 above, except that the transaction takes place after the effective date of the new law. John, a single taxpayer, will sell his personal residence on January 1, 2014. He had purchased it on January 1, 2009, and used it as a rental property for the first three years until January 1, 2012. On January 1, 2012, John moved into the property and used it as his personal residence for two years. This transaction is covered under the new provisions, and John's IRC section 121 exclusion will be limited. In the five-year period ending on the date of sale (January 2, 2009, to January 1, 2014), John owned and occupied the property as his primary residence for at least two years, qualifying John for the IRC section 121(a) exclusion. For three of the five years of ownership (60%), the property was not used by John, his spouse, or former spouse as the primary residence, but was rented. This rental use will be considered unqualified use under the new law, resulting in 60% of realized gain being ineligible for the exclusion. If the realized gain after depreciation was $200,000, three-fifths (or $120,000) of this gain is disqualified and must be included in gross income.

Example 4: Assume the same facts from example 2 above, except that the transaction took place after the effective date of the new law. Under the new provision, the Rodgers qualified for the exclusion because they owned and occupied the property as their primary residence for at least two of the past five years. They will not, however, be allowed the maximum exclusion of $500,000. In the 10 years of ownership, there were a total of eight years that the property was not used as the primary residence by the taxpayer, the taxpayer's spouse, or a former spouse. The gain is now allocated under the disqualified use ratio, where the period of ownership is the denominator (10 years) and the period of unqualified use (eight years) is used as the numerator. As a result, 80% of the gain is not eligible for the IRC 121 exclusion.

As shown in examples 3 and 4, taxpayers now must answer three questions to determine whether they qualify for the maximum gain exclusion of up to $250,000 or $500,000: 1) Did the taxpayers own and use the property as their principal residence for two of the past five years? 2) Have they taken advantage of this exclusion within the last two years? 3) Were there periods of unqualified use of the property after December 31, 2008?

Exceptions

IRC section 121(b)(4)(5)(c)(ii) provides the following three exceptions relating to the determination of periods of "nonqualified use":

* any portion of the five-year look-back period that ends after the last date that the homeowner uses the property as a principal residence;

* any period, up to an aggregate of 10 years, that the taxpayer or the taxpayer's spouse is serving on extended military duty; and

* temporary absences due to change of employment, health conditions, or other unforeseen circumstances.

Waiver for time after residency. For the waiver after residency to apply, the taxpayer must establish residence at the home and later vacate, lease, or use it as a vacation home for a period of time. The waiver does not override the nonqualified use provisions of IRC section 121(b)(4)(5); it simply converts periods of nonqualified use after residency to qualified use for the purpose of computing the exclusion. Therefore, when computing the exclusion under section 121(b)(4)(5), taxpayers should note that the disqualified time includes only the period of use before permanent residency, and use this as the numerator while incorporating the years owned as the denominator.

Example 5: The Smiths, a married couple, owned a residence for the past 10 years. For the first five years, they used the residence as rental property, and then used it as their principal residence the sixth and seventh years. They placed the home up for sale at the end of the seventh year, while renting it as a vacation home until it was sold three years later. Under strict application of the new provisions of IRC section 121, in the 10 years of ownership, there were a total of eight years that the property was not used as the primary residence by the taxpayer, the taxpayer's spouse, or a former spouse - the first five years that the property was rented and the last three years that the property was used as a vacation home. However, because of the above exception, the years of usage after residency do not count as unqualified use. Therefore, the total unqualified use is five rental years of the 10 ownership years, resulting in 50% of the realized gain not eligible for exclusion.

Qualified extended duty. Disqualified use does not include taxpayers serving on qualified extended military duty (at least 50 miles away from their principal residence or required to live in government housing) for a period of up to 10 years.

Change in employment, health, or unforeseen circumstances. Under this exception, nonqualified use does not include any period, up to two yearsregardless of use-that the taxpayer is temporarily absent from the home because of a change in employment, health, or unforeseen circumstances.

Example 6: John Smith, a single individual, purchases a home on January 1, 2009, and leases it for two years. Smith then establishes residency in the home, but due to a job transfer he lives in the home for only one year and sells it two years later. Although Smith did not meet the twoyear ownership-and-use test, he still qualifies for partial gain exclusion under an exception to IRC section 121. The two years that Smith was away due to a job transfer are not considered nonqualified use. Since Smith's move was for a change in employment and he occupied the home as his principal residence for one year, his exclusion is limited to $125,000 rather than $250,000. Therefore, two-fifths, or $50,000, of Smith's $125,000 exclusion is included in gross income, while the other $75,000 is excluded.

Transition Rule

IRC section 121(b)(4)(5)(C)(i) defines nonqualified use as any period (other than the portion of any period preceding January 1, 2009) during which the property is not used as a principal residence. Therefore, taxpayers who purchased homes before January 1, 2009, but have not established residency cannot incur nonqualified use until the effective date of the new law.

Example 7: Jackson purchased a home on January 1, 2007, and used the home as rental property for the three-year period ending December 31, 2009. On January 1, 2010, Jackson moves into the home, uses it as his personal residence for two years, and sells it on January 1, 2012. Under the transition rules, the property's status as nonqualified use does not become effective until on or after January 1, 2009; therefore Jackson has only one year of nonqualified use-2009.

Opportunities

The provisions in the Housing Assistance Tax Act of 2008 were designed to close a tax loophole and to limit the amount of the exclusion taken by certain taxpayers owning vacation or rental properties under IRC section 121. These individuals can still take advantage of the exclusion and avoid the disqualified use designation in either of two ways. First, taxpayers contemplating purchasing a vacation home or rental property after January 1, 2009, but wishing to take advantage of IRC 121 without the limitation in the future, can move into the property after purchase, meet the residency requirement, and convert the property to vacation or rental property later, selling the property within three years without losing the exclusion. Taxpayers with vacation or rental properties purchased after January 1, 2009, and who have not established residency may be able to lessen the impact by establishing residency in the property as soon as possible. Once residency is established, the taxpayer can move out of the property, converting later use to qualified use in order to take advantage of the limited exclusion if the property is sold within three years.

In general, under the old law, once a taxpayer qualified for the exclusion, he was able to exclude realized gains of up to $250,000 for single taxpayers or $500,000 for married taxpayers filing a joint return. To qualify for the exclusion, there is a five-year look-back period within which the taxpayer must own and use the property as his primary residence, and must not have used the exclusion within the past two years. Under the new law, the same conditions apply for the taxpayer to qualify for the exclusion. The amount of realized gain exclusion is reduced, however, if there are periods of unqualified use during the period of ownership. Disqualified use can only occur in years beginning after 2009.

Richard L. Russell, JD, MBA, CPA, is an assistant professor of accounting at Jackson State University, Jackson, Miss. Robert Clovey, MS, CPA, is an assistant professor of accounting at York College/CUNY, Jamaica, N.Y.