

### NEW TAXES WHEN SELLING A HOME

September 2008

A few years ago, Congress passed a simplified set of rules for determining how much of a gain would be taxed upon the sale of a personal residence. While simplified, the rules were not entirely simple but boiled down to most people being eligible for up to a \$250,000 tax-free gain, and \$500,000 for married joint filers if they used the home as primary residence for two of the five years prior to sale. In an effort to prevent claiming the entire home sale toward capital gains exclusion (even though some of the appreciation occurred when the property wasn't being used as a primary residence), new rules under the Housing and Economic Recovery Act of 2008 make the amount of tax free gain lower and harder to assess if the residence has any so-called "non-qualifying use."



Non-qualifying use is defined as any time during which the property is not being used as a primary residence. This could be use as a vacation home, rental property, business property, vacant/investment property, etc.

**Example 1:** A married couple, the Smiths, purchase a vacation home for \$300,000. After three years of using the home as a vacation home when the home has appreciated to \$600,000, they move into it and make it their primary residence. After living in the property for two more years, they sell the property for \$800,000.

In the past, the entire \$500,000 capital gain (\$800,000 sale price less the \$300,000 purchase price/cost basis) would be eligible for the primary residence capital gains exclusion. Under the new rules, beginning with any sale after December 31, 2008, only the appreciation for the two years they lived in the property (qualifying use) would be eligible for exclusion; the remaining \$300,000 gain is attributable to when the property was used as a vacation home (gain that occurred during non-qualifying use). Therefore, it would be taxable as a capital gain. Further, if the property had been used as a rental, any depreciation recapture must be claimed on the sale in addition to the capital gain.

To avoid requiring a third party appraisal of the property due to changes in primary use, the new rules stipulate that gain will be allocated pro-rata across the entire time period. Consequently, an "allocation ratio" must be determined. The numerator is the time period of non-qualifying use on/after January 1, 2009 and the denominator is the total time period the property was owned. That portion of the gain is taxable. This also means the amount of gain to qualifying and non-qualifying use would apply regardless of whether the appreciation actually occurred evenly. The rules automatically assume all gain occurred evenly across the entire period of ownership.



In addition, taxpayers will only be required to count periods of non-qualifying use that begin on/after January 1, 2009. Thus, any non-qualifying use that has occurred at any point in the past, and up to the end of 2008, will not count against taxpayers when applying these new rules.

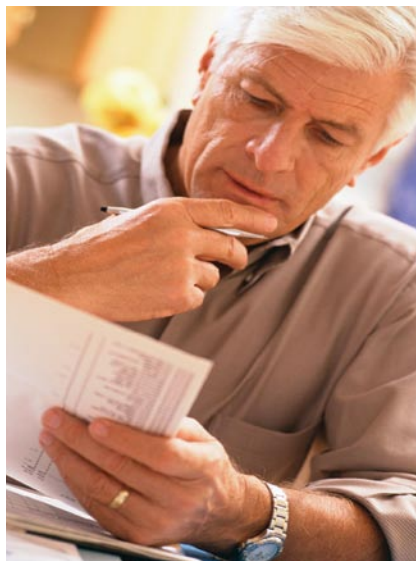
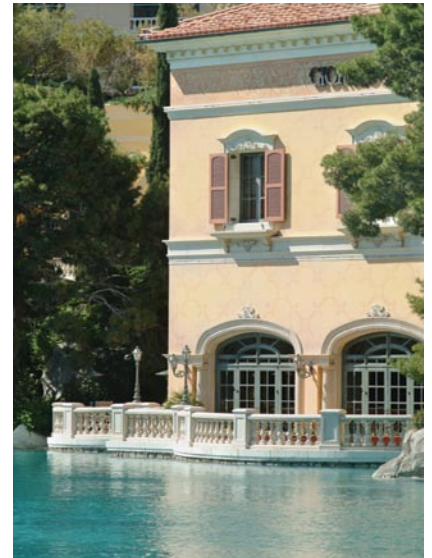
To complicate matters further, the order of use itself changes the math when applying the new rules. In the situation where the property is used first as a primary residence and later is converted to a non-qualifying use, a different set of rules apply.

**Example 2:** If Bob owns a property as his vacation home for two years (non-qualifying use), and then as his primary residence for three years, both of the years of non-qualifying use will count against him. However, under these new rules, if Bob had first used the property as a primary residence for three years, and then converted it to a vacation home for two years, none of the vacation home use will count as non-qualifying use. Because it occurred within the last five years, it occurred after the property was used as a primary residence, and the property has still otherwise been used as a primary residence for at least two of the past five years.

Only non-qualifying use that occurs after the last date the property was used as a primary residence is eligible for exclusion under these rules.

**Example 3:** Bob lives in his property as a primary residence for two years, then uses it as a vacation home for three years. He then uses it as a primary residence for another three years, and then uses it as a vacation home for one more year before selling it. In total, Bob has owned the property for a total of nine years, with five years of qualifying use as a primary residence and four years of non-qualifying use. In this case, though, only the final one year of vacation home non-qualifying use can be ignored. The preceding three year period of vacation home use – even though it followed use as a primary residence – will still count as non-qualifying use because it did not occur after the last time period the taxpayer utilized the property as a primary residence. Bob will need to count three years of non-qualifying use, and he can count the remaining six years as qualifying use.

If you own only one house, the situation is essentially the same as it was before this act was passed. Once you purchase a second property, it can get tricky.



**Example 4:** Fred lives in his property as a primary residence for five years, and then uses it as a vacation home for four years. Upon selling the property, Fred owes tax on all gains regardless of the non-qualifying use occurring after the primary residence use. Any application of the home sale capital gains exclusion rule requires that the property be used a primary residence for at least two of the past five years of ownership.

Theoretically, any time a property is not used as a primary residence, a period of non-qualifying use begins. To address this potential complication, the new rules stipulate that an absence from the primary residence will not necessarily count as a period of non-qualifying use if it is a “temporary absence” due to unforeseen circumstances. A temporary absence of up to an aggregate of two years can still qualify for exclusion even though the property wasn’t actually being used as a primary residence.

Lastly, now that some portion of capital gains may not be eligible for the home gain exclusion, tracking of cost basis for a property is more relevant than ever.

Expenditures that increase cost basis—such as the cost of improvements— can result in a smaller gain. In this case, documentation is of the utmost importance so be sure to keep all receipts. And of course, if you need assistance in making sense of any of this, give us a call.