

CONGRESS TAKETH AWAY!

The Housing and Economic Recovery ACT of 2008 Effects Changes To Section 121

Taxpayers who own a second home and want to defer the capital gain on sale have used one of two strategies to achieve tax relief. The property can be converted to rental property for a minimum of two years prior to sale and structured as a Section 1031 Exchange using a Qualified intermediary with the acquisition of new Replacement property that is also rented for the first two years after acquisition. The second method is to simply move into the second home and declare it as your primary residence for a minimum of two years and when sold use the Provisions of Section 121, Sale of Primary Residence, to exclude \$250,000 of the gain per taxpayer or \$500,000 for a married couple filing jointly.

The first strategy allows taxpayers with the ability to walk away from the deferred tax indefinitely by exchanging again and again. The second provided an outright exclusion from the capital gain tax if it did not exceed the limitations. Since the primary residence exclusion can be used every two years, a planning opportunity for full tax escape has benefited thousands of taxpayers.

The Housing & Economic Recovery Act of 2008, signed into law on July 30, 2008, contains a restriction on the practice of converting your second home to your primary residence. It requires that the exclusion be prorated based on the time the property was used as a second home. The portion of the profit that will be taxed is based on the ratio of the time after 2008 that the home was used as a second residence or rented out to the total time that the taxpayer owned the property. The balance of the gain will remain eligible for the Section 121 Exclusion.

To illustrate the point; a second home is owned for five years and converted to a primary residence after 2008 for two years prior to sale. At sale, the taxpayer will pay capital gain tax on 2/7 or 28.57% of the gain, the balance will be excluded up to the Section 121 limitations. The longer a property is owned, the lower the ultimate tax will be.

CONGRESS GIVETH

First-time Homeowner Tax Credit

The Housing & Economic Recovery Act of 2008, signed into law on July 30, 2008, provides an attractive tax credit for first time homebuyers. A first time homebuyer is someone who has not owned a home in the preceding three years. All homes, whether single-family, town homes or condominiums or new construction will qualify, however it must be used as the taxpayer's primary residence.

The tax credit is for 10% of the purchase price, up to \$7,500, but phases out for higher-income homeowners. Homebuyers who file as single or head-of-household can claim the full \$7,500 if their adjusted gross income is less than \$75,000. For married couples filing a joint return, the income limit doubles to \$150,000. Homeowners are eligible for the tax credit if they have purchased a home since April 8, 2008 or make a purchase before July 1, 2009.

This is a tax credit, not a deduction. It reduces the homeowners' tax bill by up to \$7,500 for the tax year in which the purchase was made. If you pay less than \$7,500 in federal income taxes, then the government will write a check for the difference in the same manner as an overpayment of your taxes.. If a house is purchased this year, a tax credit for the 2008 tax year can be taken with a filing deadline of April 15, 2009. If a house is purchased next year by the end of June, a tax credit for the

2009 tax year can be taken in the April 15, 2010 filing. It's a one-time credit; you don't get to keep taking it year after year.

There is a catch, and that is that the money has to be repaid over 15 years, starting two years after you buy the house. That makes the tax credit an interest-free loan. If you take the full \$7,500 tax credit, your income tax bill will increase by \$500 a year for 15 years. If you sell the house before then, you'll have to pay Uncle Sam the remaining balance.

SECTION 121 EXAMPLE

"Congress did restrict a break for turning a second home into a main home: Some of the gain will be ineligible for the home-sale exclusion if the house is converted to personal use after 2008 and is later sold. The portion of the profit that's taxed is based on the ratio of the time after 2008 when the house was used as a second residence **or rented out** (emphasis added) to the total time that the seller owned the house. The rest of the gain remains eligible for the home-sale exclusion of \$500,000."

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Taxpayer's original cost in his Relinquished Property is \$100K, with \$50K of depreciation already taken.

Sale price is \$400K, no debt, QI receives \$400K (neglect expenses).

Replacement Property is a Single Family House (SFH) costing \$400K on 1/1/09; adjusted basis is \$50K.

Owner enters the house as his home on 1/1/11, and sells it on 1/1/14 for \$600K. During the rental period he claimed \$10K more depreciation. Adjusted basis on 1/1/11 is \$40K.

Indicated gain at time of sale is \$560K. Under the OLD RULE, this married taxpayer would pay tax on \$60K, and exclude \$500K of the gain. Under the NEW RULE, this married taxpayer must make the following calculation:

Owned 5 years (denominator), rented for 2 years (numerator); $2/5 \times \$560K$ gain is \$224K recognized, balance excluded.

The incentive is to reduce this fraction by either owning the property longer (increases denominator) or renting it out for less time (reduces numerator, but flies in the face of Rev. Proc. 2008-16).

It seems that the days of simply buying an SFH (or a series of SFH's) with your exchange dollars, and later converting it (them) to your principle residence(s), selling and eliminating \$500K at a time are over.