

2008 Legislation Update - Second Homes

Tax Law Changes Start in 2009

Within the 600+ pages of the new housing bill recently signed into law is a complicated tax-code change that will affect a number of our clients who purchased second homes or rental investment real estate with a plan to occupy them as their main residence later.

The bill narrows the use of the IRC's tax-free exclusion that allowed sellers of principal residences to escape taxation on the first \$500,000 of their profits (married joint-filers) or \$250,000 (single-filers).

Before January 1, 2009, if you sell, you can claim the full exclusion if you have used a property as your principal residence for at least two of the five years preceding a sale.

You would also claim the exclusion even if you converted an investment property or vacation house into your principal residence and live there for at least two years.

This flexibility was a boon to many tax-wise owners of multiple houses, particularly during the bubble years when values doubled in many parts of the country.

Property owners in markets with high appreciation rates were selling their principal residences for hefty profits — pocketing the first \$250,000 or \$500,000 tax-free — and then moving into their rental condo or vacation property for a couple of years and repeat the process.

In effect, this provided a form of financial savings where taxable profits were magically transformed into tax-free gains up to the \$250,000 and \$500,000 limits.

Qualified and Nonqualified Periods

The tax savings strategy and practice described above caught the eye of tax reformers on Capitol Hill. So in the summer of 2008, the House approved a bill that ratcheted down the rules on such transactions by distinguishing between "qualified" periods of principal residence use and "nonqualified" periods of rental or investment use.

The expected result of this housing bill's "revenue offset" provides a vehicle to raise an extra estimated \$1.4 billion in tax revenues over the next decade.

How the New Tax Law Works

If you buy a second home or investment property after December 31, 2008, and convert it later into your principal residence and then sell, you will need to allocate any gain from the sale between periods of qualified and nonqualified usage.

Rental or second-home usage before 2009 is grandfathered — it won't count as nonqualified use in the equation.

The minimum period for qualified principal residence use will remain as-is under the current law — two years out of the five preceding the sale.

Any nonqualified use will be totaled up to limit the amount of the tax-free exclusion you are allowed.

Sellers will need to create a fraction against which to multiply their total gain.

The numerator (top number) being the time period the house was used as something other than a principal residence, and the denominator (lower number) the total period of ownership.

Example:

Below is the hypothetical example prepared by the congressional Joint Tax Committee to illustrate how the computation functions.

Situation: You are a single taxpayer and buy a house on January 1, 2009 for \$400,000.

You rent it out for two years and write off \$20,000 in depreciation.

Then on January 1, 2011 you decide to convert the rental house into your principal residence. You live there for two years. On January 1, 2013 you move out and put the place up for sale.

On January 1, 2014 you complete the sale of the house for \$700,000.

As under current law, the \$20,000 of depreciation write-offs is treated as gross income.

The two years of use as a principal residence qualifies you for some amount of tax-free exclusion on the \$300,000 gain.

How much? To figure your taxable portion, divide your aggregate period of nonqualified use (the two rental years) by your total period of ownership (five years) and multiply that fraction (two-fifths or 40 percent) against your total gain of \$300,000.

The resulting number is the amount that is subject to capital gains taxation — \$120,000 in this case. But the remaining \$180,000 is tax-free.

What Changed:

The same scenario of facts under the pre-2009 tax code allows you to claim the maximum \$250,000 exclusion for singles.

The \$70,000 difference in the Tax Committee's hypothetical illustrates why the tougher rule is expected to raise millions in tax revenues.

If the facts were changed in the example and you lived in the house for five years (2011-16), you'd get the full \$250,000.

Bottom line: If you plan to buy, reside in or sell a second home or rental investment property after January 1, 2009, be aware of the new allocation formula.

Any real estate purchase or change in usage represents a major change in most clients' financial future. Therefore, we advise you to talk with us before making shifts in your real estate portfolio to ensure all your bases are covered.

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