

## NEW RULES FOR TAXING GAIN WHEN A SECOND HOME IS CONVERTED TO A PRINCIPAL RESIDENCE

### CHANGES TO THE \$500,000 EXCLUSION

**Effective January 1, 2009**

The 2008 Housing and Economic Recovery Act (HERA), H.R. 3221, included a \$16 billion package of tax incentives intended to facilitate refinancing and also to encourage first-time purchasers to come into the market. These tax incentives required offsets so that the housing package would be revenue neutral. Only one offset was real estate-related. That change, described below, provided \$1.4 billion of revenue to “pay for” the \$16 billion of incentives. (The balance comes from the credit card industry and from some multinational corporations.)

This real estate-related provision affects only a limited set of circumstances. The new revenue raiser modifies the application of the \$250,000/ \$500,000 exclusion, but **ONLY** in situations in which an individual who owns a second home converts the second home to use it as his/her principal residence. *When the former second 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 homes are *any* residences the individual owns that are not used as a principal residence. Thus, both vacation and rental properties could be affected.

Another way to describe the goal of this change: 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 that becomes a principal residence to compute the exclusion amount and any taxable gain based on the *use* of the property. Gains from investment/rental *use* will be taxed as investment gains at capital gains rates, just as gains from a second home or investment property would be taxed if the owner had never lived in the residence. Gains from principal residence *use* will be taxed under principal residence rules and, depending on the amount of gain, be eligible for part or all of the \$250,000/\$500,000 exclusion.

Starting January 1, 2009, individuals who convert a second 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 ( $\$300,000 \times .60$ ) will be treated as a capital gain. If the capital gains rate in 2014 is still 15%, the total tax would be \$27,000 ( $\$180,000 \times .15$ ). Since the remaining \$120,000 of gain is less than \$250,000, \$120,000 is eligible for the exclusion. Thus, the tax rate on the total \$300,000 gain is 9% (\$27,000 tax liability divided by \$300,000 total gain). 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:  $2/35 \times \$775,000 = \$44,285$

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)

Total Tax Liability: \$41,250 ( $\$34,607 + \$6,643$ )

Tax Rate on TOTAL gain: 5.3% (Tax liability divided by amount of gain:  $\$41,250 / \$775,000$ )

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%.)

Example 4: Estate Tax Implications: Same fact as #3, but Fred and Ethel both die in 2018, still owning and living in the townhouse. Their children inherit the property. All estate tax liabilities have been satisfied, but the heirs don't want to live in the townhouse or maintain it as a rental property. In 2019, they sell the townhouse for \$900,000. The townhouse had a fair market value of \$825,000 when Fred and Ethel died. (Assume that in 2018 any estate tax rules still permit a stepped-up basis; i.e., the value of the property in the hands of the heirs is the same as the fair market value on the day of their parents' death.)

The property has been a rental property, a principal residence and part of an estate. When the heirs sell the property, they are permitted to treat the property as if it had been their own principal residence, so long as their parents had lived in the home for two of the five years before their death. Their gain on the sale is \$75,000 (\$900,000 - \$825,000). The \$75,000 gain may be excluded from taxation under the \$500,000 exclusion rules.

If the estate tax rules are changed and require the heirs to use the same basis their parents had in the house, the result would be very different (and, as a practical matter, very difficult for the heirs to ascertain). If, for example, the parents' basis had been \$125,000 and the heirs sold the property for \$900,000, they would have a taxable gain of \$775,000. \$500,000 would be excluded. The remaining \$275,000 would be subject to capital gains taxes at the rate in effect for 2019. It is not clear how any depreciation recapture amount would be taxed. Unless there are meticulous records, the heirs would have a difficult time ascertaining the correct amount.

#### *Policy Considerations:*

- No tax benefit is completely eliminated. New limits will apply in some cases.
- 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 home* (whether or not it is rented out) *or as a rental investment*, 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.

- The original policy objective of the \$250,000/\$500,000 exclusion was to provide tax benefit for property that is *used as a principal residence*. Thus, the new rule allocates the exclusion *only* to use as a principal residence.
- In all events, the full amount of a gain on the sale of the second home that is converted to a principal residence after 2008 will be taxed at lower rates than gains on the sale of a second home that is not converted to principal residence use. This is because part of the gain associated with use as a principal residence will be non-taxable. (See Examples #1 and #2.)
- The taxpayer still qualifies for capital gains treatment on the amount of gain that cannot be excluded. Owners of second homes that are never converted to principal residences will continue to pay capital gains taxes on the full amount of any gain plus any applicable depreciation recapture.
- The formula does not penalize individuals who own non-principal residence property before 2009.
- After 2008, when a second 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.