

Amendment to Sec.121 May Affect 1031 Exchange Planning

The Housing Assistance Tax Act of 2008, signed by President Bush on July 30, 2008, includes a modification to the Section 121 exclusion of gain on the sale of a primary residence. This modification may affect taxpayers who exchange into a residential property, and then later convert the property to a personal residence, as explained below.

Under Code Section 121, a taxpayer can exclude up to \$250,000 (\$500,000 for married couples filing jointly) of gain realized on the sale of a principal (primary) residence if they have owned and occupied the residence for two years during the five year period preceding the date of sale. Gain related to depreciation deductions taken on the property since May 6, 1997 is not eligible for exclusion.

Effective January 1, 2009, the exclusion will not apply to gain from the sale of the residence that is allocable to periods of "nonqualified use." Nonqualified use refers to periods that the property is not used as the taxpayer's principal residence. This change applies to use as a second home as well as a rental.

How does this affect 1031 planning? Suppose the taxpayer exchanged into the residence and rented it for three years, and then moved into it and lived in it for two years. The taxpayer then sold the residence and realized \$300,000 of gain. Under prior law, the taxpayer would be eligible for the full \$250,000 exclusion and would pay tax on \$50,000. Under the new law, the exclusion would have to be prorated as follows (the example does not take into account depreciation taken after May, 1997, which is taxable anyway).

- Three-fifths (3 out of 5 years) of the gain, or \$180,000, would be ineligible for the \$250,000 exclusion.
- Two-fifths (2 out of 5 years) of the gain, or \$120,000, would be eligible for the exclusion.

Importantly, nonqualified use prior to January 1, 2009 is not taken into account in the allocation. Thus, suppose the taxpayer had exchanged into the property in 2007, and rented for 3 years till 2010 prior to the conversion to a primary residence. If the taxpayer sold the residence in 2012 after two years of primary residential use, only the 2009 rental period would be considered in the allocation. Thus, only one-third (1 out of 3 years) of the gain would be ineligible for the exclusion.

The allocation rules only apply to time periods *prior* to the conversion *into* a principal residence and not to time periods *after* the conversion *out of* personal residence use. Thus, if a taxpayer converts a primary residence to a rental, and otherwise meets the two out of five year test under Section 121, the taxpayer is eligible for the full \$250,000 exclusion when the rental is sold. This rule only applies to periods after the *last* date the property is used as a principal residence. Therefore, if the taxpayer used the property as a principal residence in year one and year two, then rented the property for years three and four, and then used it as a principal residence in year five, the allocation rules would apply and only three-fifths (3 out of 5 years) of the gain would be eligible for the exclusion.