

Elder Client PLANNER

Home sale exclusion isn't available for "nonqualified use"

TAX: Gain on the sale of a principal residence may not be excluded for periods of "nonqualified use," but under generous transition rules, taxpayers may still qualify for a few years.

By David M. Fogel, CPA

Guest Contributor

Do you know that you could move out of your principal residence, convert it to rental property, rent it for three years, then sell it and pay tax on only the portion of the gain that represents the rental depreciation deductions?

This is one of the loopholes that Congress tried to close when it added IRC §121(b)(4) in the Housing Assistance Tax Act of 2008 (P.L. 110-289). Under this section, taxpayers may not use the home sale exclusion for periods of "nonqualified use." This provision was intended to raise \$1.394 billion in tax revenue

over ten years.¹ However, due to generous transition rules, the IRS may not see any of this money for quite a while.

If a taxpayer sells a principal residence, up to \$250,000 of the gain on the sale (\$500,000 on a joint return) may be excluded from income if, during the five-year period ending on the date of sale, the property was owned and used by the taxpayer as the principal residence for periods totaling more than two years.² Since the taxpayer only has to use the property as the principal residence for two years, the taxpayer can move out of the residence, rent it to tenants for up to three years during the five-year period, and still qualify for the exclusion.³ If this happens, the taxpayer won't be able to exclude gain attributable to depreciation deducted after May 6, 1997,⁴ but the remainder of the gain will qualify for the exclusion.

Last summer, Congress tried to close this loophole by adding a special rule for "nonqualified use."⁵ Under the new rule, if the taxpayer uses the property for purposes

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Health insurance beyond employment

HEALTH INSURANCE: For employees who retire or lose their jobs, health insurance options may be unstable or expensive.

By Kathryn Zdan

ECP Staff

Health insurance has been getting a lot of attention lately, but what about people who are faced with changing health care options? Employees who are retiring or who have recently lost a job are faced with an even tougher situation because their choices may be limited or very expensive. This article looks at health care for retirees as well as options for individuals who are no longer receiving employer-provided health insurance.

Retiree plans

Employers are not required to offer continued health benefit to retired employees. For those who do have benefits after retirement, it is important to review the plan documents to understand how that plan works with Medicare: i.e., which services are offered through the plan versus through Medicare, which services are not covered at all, and how secure the benefits are.

Retiree plans are as varied as the individuals they insure; there are no standards that govern the structure of such benefits, they are offered at the discretion of the employer, and may be very different from the plan the employer provides to employees. Some companies pay the entire premium and some require the participant to pay some or all of the premium. The retiree may have the same health plan

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Elder Client
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other than the principal residence, gain allocable to that use would not be eligible for the home sale exclusion.⁶ The allocation is made by dividing the period of nonqualified use by the period of time that the taxpayer owned the property.⁷

There are several exceptions to the use rules. "Nonqualified use" does not include:

1. Any period before January 1, 2009;
2. Any portion of the five-year period which is after the last date that the property was used as the taxpayer's (or taxpayer's spouse's) principal residence;
3. Any period (not to exceed a total of ten years) during which the taxpayer or the taxpayer's spouse is serving on qualified official extended duty for the uniformed services, foreign service or intelligence community; or
4. Any other period of temporary absence (not to exceed a total of two years) due to change of employment, health conditions, or such other unforeseen circumstances as may be specified by the IRS.⁸

A few examples will help illustrate these rules.

Example 1

Joan buys property on January 1, 2009, for \$400,000 and uses it as her principal residence for two years. On January 1, 2011, she moves out and rents the house to a tenant. On January 1, 2013, she sells the property for \$600,000. Between January 1, 2011, and January 1, 2013 (the rental period), Joan deducts a total of \$15,000 in depreciation. She realizes a gain of \$215,000 on the sale (\$600,000 selling price minus \$385,000 adjusted basis).

In this example, \$15,000 of the gain is taxable as unrecaptured §1250 gain.⁹ The remaining \$200,000 gain qualifies for the home sale exclusion because the rental period occurred after the last date that Joan used the house as her principal residence.¹⁰

Example 2

The facts are the same as in Example 1 except that the periods that Joan uses the property as a personal residence and as a rental are reversed. Joan rents the property to tenants between January 1, 2009, and January 1, 2011, and uses the property as her principal residence from January 1, 2011, to January 1, 2013.

As in Example 1, \$15,000 of the gain is

taxable as unrecaptured §1250 gain. In addition, since Joan rents the property to tenants for two out of four years, or 50% of the time, 50% of the remaining \$200,000 gain (\$100,000) is allocated to nonqualified use, is not eligible for the exclusion, and is taxable as long-term capital gain. The remaining \$100,000 gain qualifies for the home sale exclusion.¹¹

Example 3

George and Gracie buy property on January 1, 2005, for \$400,000 and use it as their principal residence for three years. On January 1, 2008, they move out and rent the house to a tenant. Three years later, on January 1, 2011, they sell the property for \$700,000. Between January 1, 2008, and January 1, 2011 (the rental period), they deduct a total of \$20,000 in depreciation on their joint returns. They realize a gain of \$320,000 on the sale (\$700,000 selling price minus \$380,000 adjusted basis).

In this example, \$20,000 of the gain is taxable as unrecaptured §1250 gain.¹² The remaining \$300,000 gain qualifies for the home sale exclusion because:

1. George and Gracie used the house as their principal residence for 2 years (January 1, 2006 to January 1, 2008) during the five-year period ending on the date of sale (January 1, 2006 to January 1, 2011);
2. The rental period prior to January 1, 2009 (January 1, 2008 to December 31, 2008) is not considered "nonqualified use;"¹³ and
3. The entire rental period (January 1, 2008 to January 1, 2011) occurred after the last date that George and Gracie used the house as their principal residence (January 1, 2008) and is also not considered "nonqualified use."¹⁴

Example 4

Linda buys property on January 1, 2009, for \$400,000 and uses it as her principal residence for two years. On January 1, 2011, she is given a temporary 18-month assignment by her employer to work in an office located across the country. She leaves her residence vacant during this time. On July 1, 2012, Linda returns to the area and rents the house to a tenant. On January 1, 2014, she sells the property for \$600,000. Between July 1, 2012 and January 1, 2014 (the rental period), she deducts a total of \$10,000 in depreciation. She realizes a gain

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of \$210,000 on the sale (\$600,000 selling price minus \$390,000 adjusted basis).

In this example, \$10,000 of the gain is taxable as unrecaptured §1250 gain.¹⁵ The remaining \$200,000 gain qualifies for the home sale exclusion because:

1. Linda used the house as her principal residence for two years (January 1, 2009 to January 1, 2011) during the five-year period ending on the date of sale (January 1, 2009 to January 1, 2014);
2. The period that Linda was temporarily assigned by her employer to work across the country (January 1, 2011 to July 1, 2012) is not considered “nonqualified use;”¹⁶ and
3. The entire rental period (July 1, 2012 to January 1, 2014) occurred after the last date that Linda used the house as her principal residence (January 1, 2011) and is also not considered “nonqualified use.”¹⁷

Conclusion

Although Congress eliminated the home sale exclusion for periods that taxpayers

use their house for purposes other than the principal residence, generous transition rules may be applied to reduce or eliminate gain that might be taxable. Understanding these rules will help you take full advantage of the home sale exclusion for your clients and to provide them with valuable tax planning advice. **S**

- 1 See “Estimated Budget Effects of the Tax Provisions Contained in H.R. 3221, the ‘Housing and Economic Recovery Act of 2008’” by the Joint Committee on Taxation (JCX-64-08, July 23, 2008)
- 2 IRC §121(a)
- 3 See Example 2 at Treas. Regs. §1.121-1(e)(4)
- 4 IRC §121(d)(6)
- 5 IRC §121(b)(4), added by the Housing and Economic Recovery Act of 2008 (H.R. 3221, P.L. 110-289)
- 6 IRC §121(b)(4)(C)(i)
- 7 IRC §121(b)(4)(B)
- 8 IRC §121(b)(4)(C)(i) and (ii)
- 9 IRC §121(d)(6)

- 10 IRC §121(b)(4)(C)(ii)(I)
- 11 This is similar to Example 1 in the Technical Explanation of H.R. 3221 prepared by the Joint Committee on Taxation (JCX-63-08, July 23, 2008)
- 12 IRC §121(d)(6)
- 13 IRC §121(b)(4)(C)(i)
- 14 IRC §121(b)(4)(C)(ii)(I)
- 15 IRC §121(d)(6)
- 16 IRC §121(b)(4)(C)(ii)(III)
- 17 IRC §121(b)(4)(C)(ii)(I). This section uses the word “after,” not “immediately after”

About the author

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as active employees, or there may be several options from which to choose.

The way the retiree plan interacts with Medicare coverage will also vary. It is very important to read and understand the plan documents for any details concerning Medicare. For instance, some retiree plans that offer prescription coverage may terminate *all* benefits if the retiree enrolls in Medicare Part D (prescription coverage).¹ If a retiree plan offers prescription coverage that is as good as or better than Medicare Part D, the retiree plan coverage is “creditable,” meaning that the retiree is not required to buy Part D. The participant should annually receive a written notification stating whether or not their prescription coverage is creditable.

For more information about how health insurance works with Medicare, see “How Medicare works with other health plans” in the August 2008 issue of **Elder Client Planner**. It is available at www.elderclientplanner.com, and is part of your subscription.

An important thing to keep in mind is that since the company or union plan is under the discretion of the employer, benefits may be terminated at any time, unless there is clear language in the plan documents that promise coverage for a specific amount of time. If there is no specific language that deals with the length of time coverage is offered, then coverage is most likely not guaranteed.²

Know how your health plan works

Here are some issues to consider when reading plan documents:

1. How does the plan work with Medicare?
2. If I move out of the geographic area, will I still be covered?
3. Will my spouse be covered?
4. Will I need to purchase Medicare Part D? How will this affect my coverage?
5. What portion of the deductible am I responsible for?
6. Is there a dollar limit on the benefits the plan will pay?
7. Can the plan change, or are benefits clearly promised for a definite period of time?

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