

Effective January 1, 2009, there are important changes for our clients who are taking advantage of IRS Section 121 tax exclusions by converting a rental property (or second home) into a principal residence.

IRS Section 121 tax incentives allow exclusion of gain, \$250,000 (single) / \$500,000 (married) on the sale of a principal residence. Beginning January 1, a second home (or rental property) that is converted to a principal residence will have to play by new rules. HOWEVER, THERE ARE EXCEPTIONS.

Under the new rules, when a second home or investment home is sold, any gain attributable to use as a second home (or rental property) will be taxed at the capital gains rate in effect at that time. Any gain attributable to use as a principal residence will remain excludable, up to the \$250,000 and \$500,000 limits. Essentially owners must now prorate the usage, whereas before they could potentially live there for 2 years and get the full exclusion... now they have to look back over the 5 year period and prorate the time spent as second home or investment and treat that based on capital gains, and the balance would apply toward the \$250,000/\$500,000 exclusion.

THERE ARE EXCEPTIONS including:

1. Any periods where the property is used other than as a primary residence that occurs prior to January 1, 2009 will not reduce the capital gain exclusion. For example, if the three year rental period occurs to January 1, 2009, the exclusion would not be reduced and a couple would be able to exclude the full \$500,000.
2. A property first used as a primary residence and later converted to investment property will not be affected by the new law. For example, a client who owns and lives in a house for 3 years and subsequently rents it for two years before selling is exempt. Because investment use occurred after the last day of use as a primary residence, all of the gain up to the maximum can be excluded.

IRS rulings are complex and our Resort Property clients should check with their financial consultants before making important decisions.