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Divorcing Your Mortgage Educational Series

The Housing Assistance Tax Act of 2008
When a Divorcing Client Moves into an Existing Rental Property

Divorce Lending Institute

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There may be a widely overlooked tax consequence as many divorcing couples who own investment properties often move into a rental home as their new primary residence.

The Housing Assistance Tax Act of 2008 provides four important tax law changes that impact individuals and small businesses. These tax laws are part of the larger Housing and Economic Recovery Act of 2008 (HR 3221, Public Law 110-289) which provides a number of laws relating to housing and mortgages.

One of the highlighted tax law changes is related to prorated capital gains exclusion for real estate for periods of non-primary use. This may be a concern for divorcing clients when one spouse retains a current investment property to be used as their new primary residence.

Under the Housing Assistance Tax Act of 2008, the IRS now wants their share of the capital gains tax during the period from January 1, 2009, up until the property becomes a primary residence.

Calculating the Potential Tax Liability

After December 31, 2008, gain from the sale of a principal residence will *not* be excluded from income to the extent the property was used for a nonqualified use, as defined under Code § 121(b)(4), as amended by Housing Act § 3092. This new restriction only applies to nonqualified uses occurring after December 31, 2008. A non-qualified use consists of any period, beginning after December 31, 2008, in which the property is not used as the principal residence of the taxpayer.

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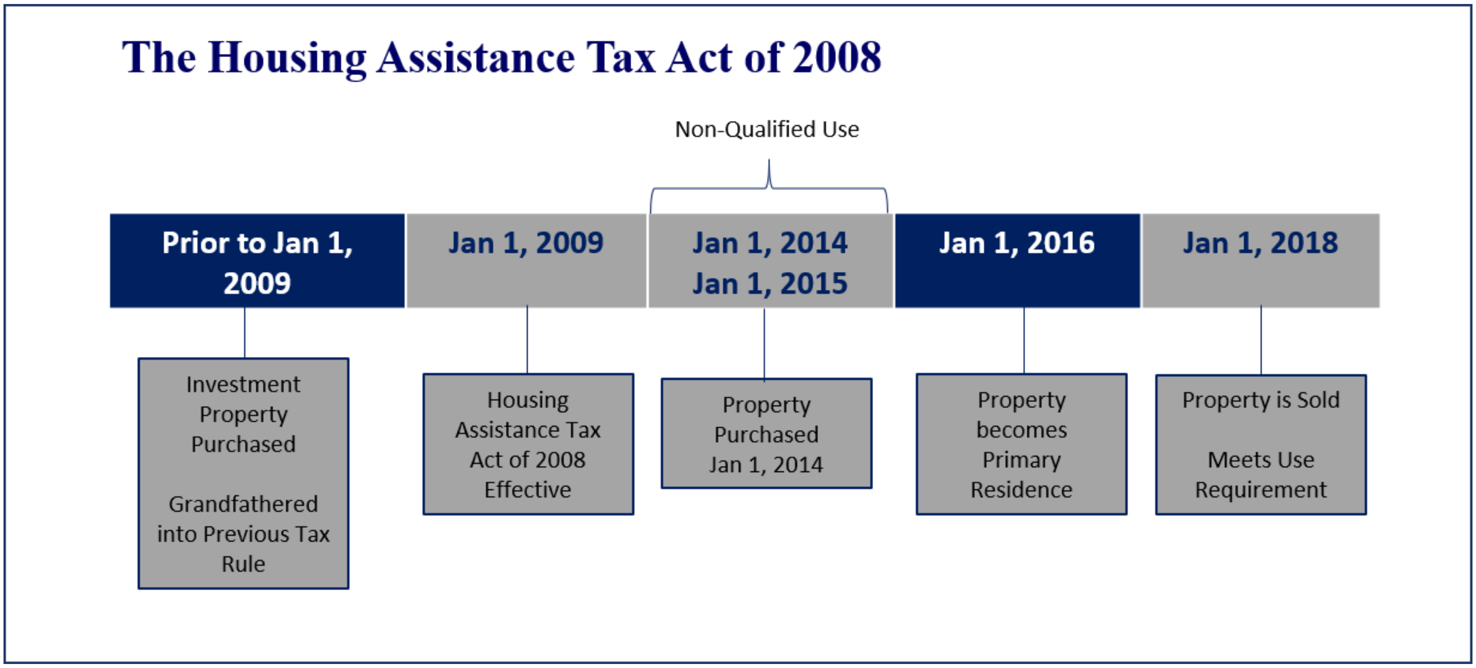

To calculate the amount of gain that is allocated to periods of nonqualified use, the total amount of gain is multiplied by the following fraction: the aggregate periods of nonqualified use while the property was owned by the taxpayer divided by the period the taxpayer owned the property. Nonqualified use, however, does not include any portion of the five-year period that occurs *after* the last date the property is used as the principal residence of the taxpayer. For example, suppose John buys a home on January 1, 2014, for $400,000 and uses it as rental property for two years, claiming $20,000 of depreciation. On January 1, 2016, John begins using the property as his principal residence. John moves out of the house and sells it for $700,000 on January 1, 2018. John used the property for a non-qualifying use for the first two years he owned it. The year after John moved out, however, is treated as a qualifying use. Therefore, 40% (two out of five years owned), or $120,000, of John's $300,000 gain is not eligible for the exclusion. The balance of the gain, $180,000, may be excluded. In addition, John must include $20,000 of the gain attributable to depreciation as ordinary income (unrecaptured Code § 1250 gain).

Nonqualified use also does not include any period during which the taxpayer or the taxpayer's spouse is serving on qualified official extended duty (not to exceed an aggregate period of 10 years), nor does it include any other period of temporary absence because of change of employment, health conditions, or other unforeseen circumstances as may be specified by the IRS (not to exceed an aggregate period of two years).

The Housing Act is intended to restrict gain exclusion when property is transferred from a nonqualifying use *to* a principal residence, so the new provisions do not restrict gain exclusion when property is transferred *from* a principal residence to a non-qualifying use. Again, this provision only applies to nonqualified uses beginning January 1, 2009.