NEW LAW CLOSES TAX LOOPHOLE ON CAPITAL GAINS

A popular tax-saving loophole regarding capital gains taxes on some primary residences has been impacted by the recently signed 2008 Housing and Economic Recovery act. The law places new restrictions on wealthy homeowners who own two or more homes and plan to "house hop" to avoid paying capital gains taxes.

Under previous law, those who sell a house for profit after living in it as their primary residence for two of the past five years would not have to pay capital gains taxes on $250,000 of the gain for a single person or $500,000 for a married couple filing jointly.

Some taxpayers have avoided the capital gains tax by selling their primary residence, claiming the full tax exclusion, then moving to a second or third home that they have owned for some time, making it their primary residence which they then sell and pay little or no capital gains tax. The new law states that the gain may not be excluded for periods of "nonqualified use," basically the period of time when the house was not used as the taxpayer's primary residence.

While the change to the law will affect only a small minority of U.S. homeowners, it will cause some tax headaches for a few. Partial exclusions will still be available in some cases, and there are some special rules for members of the uniformed services and some federal employees. Here are the basics to remember:

- The new law is effective only for sales beginning in 2009.
- Partial exclusion may still be available if the home was sold due to a change in place of employment, for health reasons or "unforeseen circumstances" such as the death of a spouse.
- The tax exclusion does not apply to portions of the gain attributable to depreciation allowed for rental or business use of the principal home for periods after May 6, 1997.
- The gain may not be excluded for periods of "nonqualified use," or any period when the property isn't used by the homeowner, spouse or former spouse as a principal residence.

Here is an example of the "unqualified use" rule: A married couple buys a home on January 1 of 2009 for $600,000 and plans to hold it as an investment. On January 1, 2012, they begin using it as their principal residence. They live there two years and sell it on January 1, 2014 for $1.1 million for a profit of $500,000.

Under the old law, the couple would have excluded the entire $500,000 gain from their taxable income. Under the new law, they can only exclude $200,000 – two-fifths – since the other $300,000 would be considered nonqualified because of the three years in which the home was not their principle residence. For more information, consult a tax professional, who may be able to identify any exceptions or other important points for individual situations.

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