nerej
EST 1963 | CELEBRATING 55 YEARS

Proposed Legislation and Converted R. E.

November 19, 2007 - Front Section

On October 3rd the House Ways and Means Committee issued HR 3648, the Mortgage Debt Relief Act of 2007. Included is a provision, effective for sales after January 1, 2008, which creates a taxable gain on the sale of a principal residence, which had been converted from rental property.

Within the last decade, residential R.E. has appreciated creating some opportunities for R.E. investors. Individuals owning rental property found that the selling price was higher than their tax basis, which upon sale, would result in a capital gain. One option was to sell their principal residence, exclude the gain under the sale of principal residence regulations, move into the rental, and convert it to their principal residence. From there, maintain the house as their principal residence for two years, sell the home and exclude up to $500K of gain. They would be required to recapture the depreciation taken while the home was a rental.

The proposed legislation ends this scenario. Sale of a primary residence which had been converted from a rental property within the 5 years prior to sale would be subject to tax. The period prior to conversion from rental, would be considered to be "non-qualified use" and would not be eligible for the $500K gain exclusion. There would be an allocation measured by the time the property was held as rental / total time the taxpayer owned the property. The allocated percentage would then be applied to the gain on sale, and a tax would be assessed on the non-qualified use percentage. This proposal only applies to conversions from rental to personal use within five years.

Norman Posner, CPA, MST, Samet & Co. PC Chestnut Hill, MA. Ron Mustacio, CPA, MST, also with Samet, contributed to this article.