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Home-sale exclusion now limited if home was not originally your principal residence

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Homeowners receive a significant tax break when they sell their principal residence. A married couple filing a joint return can exclude up to $500,000 of the gain on the sale of their principal residence. In a period of declining real estate values, the exclusion may shelter the entire gain. A home must qualify as a principal residence in order to benefit from the exclusion. Generally, the taxpayer must own and use the home as his principal residence for at least 2 years out of the 5-year period ending on the sale date, although the qualifying ownership and use need not be coexistent. The exclusion may not be claimed more than once in a 2-year period. Prior to January 1st, you could exclude the entire gain even if a home was originally your second home and then became your principal residence. Thus, you could move into your vacation home, convert it into your principal residence, and as long as you met the 2-year ownership and use test, you could potentially exclude the entire gain on the sale.

Not any more. Under the Housing Assistance Tax Act of 2008, the exclusion does not apply to the portion of the gain that is attributable to the "period of nonqualified use," that is, the period after 2008 in which the home is not your principal residence. Now, if you sell your principal residence that originally was your vacation home, gain must be allocated between qualified use and nonqualified use based on a fraction, and the gain attributable to the nonqualified use is ineligible for the exclusion. The full impact of this provision may not be felt until home prices begin to rise. Because gain is allocated to pre-conversion use based on the ratio which nonqualified use bears to the period the home was owned by the taxpayer, an appraisal of the home's value as of the date of conversion will not help you establish that the appreciation is attributable to the period of qualified use. Of course, the exclusion also does not avoid the gain attributable to depreciation if the property was rented.

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