

Nonqualified Use of Principal Residence

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In 2008, Congress introduced a new requirement under IRC §121 to limit the gain from sale of home where an individual lives – otherwise known as principal residence. For an individual who owns two homes, the principal residence is the one where the individual spends the majority of his/her time. When an individual is not using his home as principal residence, the new law treats it as non-qualified use and the gain related to non-qualified use is taxable as capital gain.

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IRC §121 exclusion provision provides that when an individual sells a principal residence, he/she can exclude gain up to \$250,000 (or \$500,000 for married individuals filing a joint return). To claim the exclusion, the individual must have:²

- Owned the home for two out of five years before the sale.
- Used the home as principal residence for period totaling two years out of the five years before the date of sale (For the \$500,000 exclusion, both married individuals must meet the use requirement).
- Not claimed the exclusion on sale of home in the last two years.

If the individual fails to meet these requirements, the entire gain is taxable unless the individual sells the home due to employment, health, or unforeseen circumstances.³ Also, the individual cannot exclude any depreciation claimed on the property for any period after May 6, 1997. If an individual has already claimed depreciation on home, he/she must recapture depreciation as a gain which will be taxed at the preferential rate of 25%.⁴

Many individuals abused the tax-benefit provisions by converting their rental or investment properties into principal residences and then selling them after meeting the use requirements.⁵ By doing so they were excluding the entire gain amount up to \$250,000 (or \$500,000 for married individuals filing joint returns).

To stop this practice, Congress added a new rule on non-qualified use of principal residence when it passed the “Housing and Economic Recovery Act of 2008.”⁶ Now, an individual cannot exclude the portion of gain which belongs to non-qualified use of principal residence from his/her gross income.⁷ Please see Equation 1 for computing gain allocable to nonqualified use below.

$$\frac{\text{Total Period of non-qualified use}}{\text{Total ownership period}} \times \text{Gain on sale of property}$$

Equation 1: To compute gain allocable to non-qualified use according to IRC §121(b)(4)(B)

1 IRC §§1221 to 1223.
 2 IRC §§121 (a) and (b); Reg. §§1.121-1(a) and (c); and Reg. §1.121-2(b).
 3 IRC §121(c), and Reg. §1.121-3.
 4 IRC §1250 on unrecaptured gain.
 5 Joint Committee on Taxation Report. JCX-63-08, Retrieved from <http://www.jct.gov/s-1-09.pdf>
 6 PL 110-289 Sec. 3092.
 7 IRC §121(b)(4). The new law does not affect the non-qualified use period before Jan. 1, 2009.

The term “period of non-qualified use” means any period during which the home was used as a rental or investment property and not as principal residence by an individual.⁸ However, the following are exceptions to the period of non-qualified use:

- Any period after the last day home was used as the principal residence by an individual until the date of sale. Also, such period should be within 5 years before the date of sale.⁹
- Any period (not more than 10 years) during which an individual served on qualified official extended duty.¹⁰
- Any other period of temporary absence (not more than 2 years) due to health conditions, change of employment, or other unforeseen circumstances (as provided in law).¹¹

Here is an example to illustrate the difference between the current and prior laws on gain exclusion.

Facts

- Taxpayer X buys a home on January 1, 2007 for \$600,000 and rents the place until December 31, 2011.
- From January 1, 2012 to December 31, 2016, X lives in it.
- On January 1, 2017, X moves out and rents the place until December 31, 2018.
- On January 1, 2019, X sells the house for \$800,000. The depreciation claimed on the property when rented was \$50,000.

Issue

How much gain will X recognize on the sale of home?

Computation of gain

Equation 2 illustrates the computation of the adjusted basis and net gain on sales, and the classification of depreciation recapture and gain.

Cost Basis	\$600,000
Less Depreciation.	(50,000)
Adjusted Basis (a)	550,000
Sale Price (b)	800,000
Net Gain in sale (b-a)	250,000

- **\$50,000: Depreciation Recapture**
- **\$200,000: Gain to be considered for exclusion**

Equation 2: Computation of capital gain

8 IRC §121(b)(4)(C)(i).
 9 IRC §121(b)(4)(C)(ii)(I).
 10 IRC §121(b)(4)(C)(ii)(II).
 11 IRC §121(b)(4)(C)(ii)(III).

Analysis

- No exclusion for depreciation deducted. Depreciation recapture of \$50,000 tax at the preferential rate of 25%.¹²
- X meets the requirements stated in IRC §121(a) because he owned and used the home as his principal residence for 2 out of 5 years prior to the sale.
- Therefore, for the remaining gain of \$200,000, X must determine how much gain belongs to the period of non-qualified use and cannot be excluded from his gross income.
- The period of non-qualified use begins from the date when the property was rented on or after January 1, 2009. The timeline, for use is as follows:
 1. 01/01/2007 to 12/31/2008, 2 years¹³
 2. 01/01/2009 to 12/31/2011, 3years (non-qualified use)
 3. 01/01/2012 to 12/31/2016, 5 years (qualified use)
 4. 01/01/2017 to 12/31/2018, 2 years (non-qualified use)
- The period from January 1, 2017 to December 31, 2018 will not be included as non-qualified use because of the exception that it is the period after the home was last used as the principal residence but before the date of sale.
- Therefore, the total period of non-qualified use is 3 years. X owned the property for 12 years, i.e. from January 1, 2007 to December 31, 2018.
- As shown in Equation 3, X cannot exclude the gain of \$50,000 because it belongs to the period of non-qualified use. However, X can exclude the balance gain of \$150,000 (\$200,000 less \$50,000) under IRC §121.

Period of non -qualified use	3		
Total ownership period	12	X	\$200,000 Gain = \$50,000

Equation 3: Non-qualified use gain

¹² IRC §1(h)(E)(i). Unrecaptured §1250 gain is taxed at 25%.

¹³ The new law does not affect the non-qualified use period before Jan. 1, 2009.

Conclusion

Taxpayer X will report a gain of \$100,000 (\$50,000 of depreciation recapture and \$50,000 of gain allocated to non-qualified use) on his tax return in the year of sale. Please see Table 2 which illustrates the comparison between the old and new tax law.

	Under Old Law	Under New Law
Gain On Sale (a)	\$200,000	\$200,000
Exclusion (§121)(b)	4200,000	\$150,000
Taxable Gain after exc	None	\$50,000
Depreciation recapture	\$50,000	\$50,000
Total Gain to be recognised by A	\$50,000	\$100,000

Table 2: Comparison under old and new law

Under the previous law, X would have excluded the entire gain of \$200,000. However, under the new law, X will now be able to exclude a gain of only \$150,000 from his gross income. As per the new law, the non-qualified use period starts only from January 1, 2009. Therefore, X was able to exclude gain from January 1, 2007 to December 31, 2008.

So, the points to remember about IRC §121(b)(4), the new sub-section, are as follows.

- The period of non-qualified use starts from January 1, 2009.
- Non-qualified use means the period during which home was not used as the principal residence.
- Gain allocable to non-qualified use period is taxable as capital gain.
- The non-qualified use period does not include:
 - The period after the last date the home was used as principal residence until the date of sale.
 - The period when an individual was away from home due to qualified official extended duty (not more than 10 years).
 - Temporary absence due to health, employment or other reasons (not more than 2 years).