

Exclusion of Gain on Sale of Principal Residence Limited

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September 2008

Section 121 of the Internal Revenue Code of 1986, as amended, provides an exclusion of certain gain on the sale of property owned and used as a principal residence for at least two out of the previous five years. The exclusion is \$250,000 for each taxpayer and \$500,000 for a husband and wife filing a joint return if at least one of the spouses meets the ownership requirement and both spouses meet the two-year use requirement.

Under the Housing Assistance Tax Act of 2008, gain from the sale of a principal residence allocated to nonqualified use during the period the property was owned will not be subject to the exclusion. Assume that a house in Palm Springs has been owned by taxpayer for three years as a vacation home and, upon taxpayer's retirement, the house becomes the taxpayer's and the taxpayer's spouse's principal residence. They live there for two years and then sell the house to move into a condominium. If the gain on sale were \$1 million, the gain subject to the exclusion would be \$400,000 (3/5 of \$1 million or \$600,000 attributable to nonqualified use subtracted from total gain). A substantial part, that is, \$100,000, of the \$500,000 exclusion of husband and wife would be unavailable.

Fortunately, the new provision only takes into account use after 2008 and does not apply to use after a home is no longer a principal residence. Not included in the period of nonqualified use are temporary absences of (1) taxpayer or taxpayer's spouse for extended military duty up to an aggregate of 10 years and of (2) taxpayer for reasons of employment or health (and other similar reasons to be set forth in regulations) for up to an aggregate of two years.