

real estate

Tax crackdown on second homes



Congress has changed the rules — effective as of 2009 — for vacation homes and rental properties. Here's what you need to know about paying the piper.

By Kiplinger's



Congress has pulled the rug out from under vacation- and rental-home owners planning to squeeze tax-free profit from their second homes.

Under current law, you could sell your primary residence and take up to \$250,000 of profit — \$500,000 if you file a joint return — tax-free, as long as you owned and lived in the place for two of the five years leading up to the sale.

Then you could move into your vacation home or a rental property and, by living in it for at least two years, get a second bite of the tax-free apple. Even profit that built up while it was a vacation home or rental could dodge the IRS.

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No more. To help pay for the big housing bill passed this summer, Congress has changed the rules so that some of your gain will be taxable if you convert your vacation home or rental unit to a primary residence after 2008.

The portion of the gain to be taxed is based on the ratio of nonqualified use — the time the property is used as a vacation home or rental unit after this year — to the total amount of time you owned the property.

What's your home worth?

Assume you bought a second home in 2000. Let's say you convert it to your primary residence in 2011 and sell it two years later. In this example, the home would be used as a vacation property for two years after 2008, so one seventh of the profit (two out of the 14 years you owned it) would be taxed at capital-gains rates. The remainder of the gain — up to \$500,000 for couples — would be tax-free.

This tax-law change could be even more significant if you buy a second home after 2008. In that case, none of the time it is used for vacations or rental income qualifies for the tax exclusion. But if you convert it to your principal residence, the longer you live there, the less the profit from a sale will be taxed.

Home affordability calculator

And you can avoid the crackdown altogether if you move in before the end of this year, says Raffaele Mari, a CPA in Corona Del Mar, Calif.

But what do you do with your current home? You could rent it to generate cash flow and buy some time before selling it in this slow housing market, Mari says. The tightening doesn't apply in reverse: You'd still qualify for tax-free profit on the home as long as you sell it within three years to meet the two-of-five-years test.

By Mary Beth Franklin, Kiplinger's Personal Finance