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A TAX PRIMER ON THE SALE OF YOUR PRINCIPAL RESIDENCE

By Victor Sy, CPA, MBA

Prior law allowed an once-in-a-lifetime exclusion of \$125,000 for 55 years or older taxpayers who reinvested in a more expensive home. That law is gone, replaced by a taxpayer-friendly provision that now allows **\$250,000/500,000 exclusion of gain from the sale of your primary residence**. And this you can do **every two years!** Let's explore how this new code section works – definitions, exclusions, tests, bases, multiple use, and related issues.

Background Information:

1. A residence includes living quarters that provide basic living accommodations such as sleeping area, toilet, and cooking facilities. It could be a house, condominium, town house, mobile home or houseboat.
2. Your personal residence is a capital asset; therefore, the sale or exchange can result in a capital gain.
3. Loss on the sale of your personal residence, however, is a transaction that is not entered for profit, and therefore, is not deductible.

Exclusion Of Gain:

1. You may exclude gain up to \$250,000 (\$500,000 if married filing jointly) of the gain realized on the sale of your principal residence.
2. You have to pass an ownership test and a use test.
3. You must have owned the residence for at least two of the last five years.
4. You must have occupied the residence as your principal residence for at least two of the last five.
5. You are allowed exclusion once every two years.
6. The maximum exclusion of \$500,000 applies even if only one spouse meets the ownership test provided both spouses meet the use test and the one-sale-in-two-years test.
7. The \$250,000 exclusion applies on a joint return where one or both spouses meet the ownership test but only one spouse meets the use test or the one-sale-in-two-years test.
8. There are planning opportunities to save taxes.
 - Tip 1- Sell the house before getting married.
 - Tip 2- remain married to file a joint return to avail of the whole \$500,000 exclusion.
 - Tip 3 - elect out of this exclusion for the spouse with the minimal gain and take the bigger exclusion on the house with the substantial gain. Whatever your situation is, go see your CPA, enrolled agent, or tax lawyer to plan and save capital gain taxes that could be substantial (Watch for our 10 hot tips in saving capital gains taxes on the sale of your home).

Exceptions To Ownership And Use Tests:

1. Short temporary absences such as vacations and seasonal absences are counted as periods of use and therefore O.K. Two-month annual vacations are fine.
2. Even rentals during temporary absences do not taint the use test (and are therefore O.K).
3. A one-year sabbatical absence is not a temporary absence (and is therefore not O.K).
4. Absence from the use of the house that is occupied by one spouse in a divorce case count as period of use.
5. If a residence is transferred incident to a divorce, the time during which the former spouse owned the house can be counted.
6. Your period of ownership includes period during which your deceased spouse owned & used the house.
7. Periods of ownership and use of a residence that was rolled over under an old 1034 exchange count in determining the ownership and use tests.
8. Ditto for involuntary conversions.

Reduced Exclusion:

1. If you do not pass a test, you can still avail of a reduced exclusion if the sale is due to a change in employment, health, or unforeseen circumstances.
2. The available partial exclusion is equal to \$250,000/500,000 computed with the aggregate periods during which the ownership and use tests were met.

Multiple Residences:

1. Only the sale of your principal residence qualifies for the exclusion. The facts and circumstances and the good faith of the taxpayer determine which one is the main residence.
2. Factors to consider include amount of time spent in each home, location of your business, location of children's school, voting place, car registration, bank location, church participation and others.
3. A tax court determined that a rented home was the principal residence, not the farm owned and used only on weekends and holidays.
4. Another tax court determined that a residence used on weekends by the taxpayer and full-time by his mother was not his personal residence.

Basis Of Main Residence:

1. Original basis includes the cost to purchase or construct, including escrow fees, title insurance, construction-period interest, and even seller expenses paid by the buyer such as delinquent taxes, selling commissions, and charges for improvements and repairs.
2. Basis does not include points (loan origination fees and refinancing charges).
3. A donee steps into the shoes of the donor and therefore uses the same basis in the case of a gift.
4. Basis of inherited properties depends on how title was held. The entire property gets the benefit of a step-up basis for community properties but only half step-up for joint tenancies.
5. It is therefore critical that titles be reviewed as part of your estate planning. Bring a copy of your deeds to your tax lawyer for evaluation as to the best way of owning your properties.
6. If you failed to do that and some realties remained in joint tenancy at the time your spouse dies, discuss with your estate lawyer the wisdom of disclaiming those properties to get them back to community property status and subsequently get a 100% step up in basis. This could translate to big bucks – very big tax breaks.
7. Do not forget to add improvements such as new roof, garage, family room, patio, pavements, fireplace, kitchen, and bathrooms from the time you bought the property.
8. Remember that special assessments for local improvements that arrive in the form of tax bills are additions to the basis, not tax deductions for the current year.
9. Do not forget to reduce your basis by any gain from the sale of your old home that was postponed under the old 1034 deferral rules.
10. Ditto for depreciation allowed or allowable from business or rental uses of your home. The word "allowable" is important to understand because it denotes depreciation that should have been taken but was not. You still have to reduce your basis as if you took the depreciation.
11. The business use of home (home office) deduction regained its popularity since the repeal of the Soliman case. Taxpayers using part of their residence as the only place of business will have to contend with depreciation recapture when the residence is sold.

Reporting Sale Of Multiple-Use Residences:

1. You do not have to report the sale of your main home. The old Form 2119 was eliminated.
2. Any reportable gain from the sale of your main residence should be made in Schedule D. Report the whole gain, then back out the excludable portion beneath the gain as "Section 121 exclusion."
3. Report the business or rental portion of your gain in Form 4797.

The Mortgage Relief Act created a **new exception for certain discharges of home mortgage debts** that occur from January 2007 through December 31, 2009. The new exception only applies to a debt that's used to acquire, construct, or improve a principal residence. It helps if you borrowed too much to acquire, build, or improve a principal residence. It does not apply to vacation home mortgages, a taxpayer in bankruptcy, and any factor not directly related to a decline in the value of a residence or taxpayer's financial condition.

The new law also helps **widows and widowers** get the bigger \$550,000 (instead of \$250,000) exclusion.

Mortgage Insurance premiums for qualified mortgage on your qualified residence are treated as qualified residence interest paid or accrued 1/1/07 through 12/31/10 (**extended to 12/31/11**).