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10 HOT TAX TIPS IN SELLING YOUR MAIN HOME

By Victor Sy, CPA, MBA

Considering the amount of your potential capital gain and the resulting tax that could be substantial, much could be saved in planning the sale of your principal residence. The stakes are high. If you have owned a home for decades, took a home office deduction, rented a portion of your home, or have a divorce situation, you may want to read these 10 tips. Remember that your house is a capital asset and gain from its disposition results in a capital gain that is subject to tax.

1. If you have a rental unit that was purchased before the real estate boom in California, consider moving in and making that house your principal residence for at least two years. Then sell it. Free of tax. You would be converting a taxable sale into an excludable transaction. Sure, you still have to pay tax on depreciation but that should be minimal compared to the tax on the remaining gain.

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2. If you are faced with a substantial gain on the sale of a residential or commercial rental building, consider swapping it with a single family home. Rent the house long enough to satisfy the requirements of a like-kind exchange under Internal Revenue Code 1031, then move in and occupy that house as your main home for at least two years. You may then exclude $250,000/500,000 (for unmarried/ joint filers) of capital gains tax. Sure, you may have to wait a long time but for hundreds of thousands of sheltered capital gains, I would.

3. If you bought a new house but do not want to sell the old house to wait for better prices in an escalating real estate market, consider renting it out. You can rent it out for less than three years and still avail of the $250,000/$500,000 exclusion because the Code only requires that you use it as your principal residence for at least two of the last five years. As you see the California real estate market heat up to its pre-recession levels, wait. Wait and enjoy the equity ride as it becomes a seller's market.

4. If you have an office at home, evaluate the tax savings from the use of your home as the principal place of business for at least two years prior to selling it. Only the gain on your principal residence is excludable. The depreciation from May 6, 1997 would be recaptured, meaning that you will have to pay tax on that depreciation. The basis of your home would be reduced because of the depreciation. That would cause you to pay capital gains tax. RECENT DEVELOPMENT: Final IRS regulations provide that no allocation of gain is required if both the residential and business portions of your property are within the same dwelling unit.

5. Some of you may have two homes - one in California and one in either Nevada, Florida, or some other state with no state income tax. And just by coincidence, you chose as your residence the tax-free state. If you plan to sell your California home, sit down with your tax adviser and plan your next moves. If you do not make a change of residency, you will be taxed on the sale of your California home because it is not your principal residence. Consider changing your driver's license, voter registration, church affiliation etc and claim California as your state of residence. Wait two years and sell. And save.

6. If you have a vacation house and are mulling retirement and selling your main home, consider moving into that vacation house, stay there for at least two years, then sell. You would satisfy the requirements of the new law on both houses and save big on two sets of capital gains tax. Lots of it.

7. If you love the idea of buying and making money on fixer-uppers, the new law is on your side. Buy a fixer with potential, spend the time and the money to repair it, move in for two years, and then sell. Enjoy the exclusion and the tax savings. Then buy another fixer. And enjoy the exclusion again. Be careful though into turning the inventory too often. The IRS could look at those homes as just that, inventory, and classify you as a dealer who would pay not just capital gains tax, but ordinary tax at higher rates. With proper planning on the side of conservatism, you could work it out.

8. If a married couple separates or divorces but do not sell their home for several years, the spouse moving out could lose out on the exclusion of gain. Assuming that the husband orally agrees to have the wife and child stay there for their child to finish schooling in five years, the husband could pay substantial capital gains tax because he would flunk the two-out-of-five-year use test. Don't despair though. There's a solution: Include this arrangement in your divorce or separation agreement and you will be fine. A section in the Internal Revenue Code considers you as using that property as your main home even if you didn't live there. Even if the house is sold 10 years after your departure, you may still exclude up to $250,000 of capital gain.

9. Be careful in dividing property in divorce cases if the gain on your main home exceeds $250,000. If one spouse gets the house and sells it for a gain of, say $300,000, only $250,000 will be tax-free. The other $50,000 will be taxed. One option is to stay married during the sale, stay civil, sell, and exclude the whole gain. There is no need to add tax burden to an already challenging situation. We, tax planners, get satisfaction not just from saving taxes but also relieving stress from our clients.

10. Single taxpayers who own a home with an appreciation of more than $250,000 may want to tie the knot before selling the property. If you and your live-in friend have occupied the house for two years, and assuming that you plan to get married anyway, do so before the end of the year, then sell the house. As long as both of you pass the two-year use test, the Code only requires one of you to pass the ownership test. This means that you can exclude up to $500,000 since you were married as of December 31 of that year.

Caveat: The loss on the sale of a personal residence is a personal loss and is not deductible. You cannot convert that personal loss to a deductible business loss by merely renting it out before the sale.

New Law Helps Homeowners Facing Debt Discharge Income From Foreclosures & Repossessions:

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.

Read our separate tax article on the Mortgage Relief Act of 2007.

Caveat: The $250,000/$500,000 exclusion of gain may be lost where a house is transferred to a living trust that later becomes irrevocable after the first spouse dies.