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Capital Gain Exclusion from Sale of Residence

The tax rules when selling a home may make things easy for many home owners, but rising real estate values will still necessitate good record keeping for others.

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A tax law change in 1997 regarding the sale of a principal residence allows married taxpayers to exclude from income up to $500,000 of the realized capital gain ($250,000 for single taxpayers). Ownership and use requirements apply, and the exclusion may only be used once every two years, but for many homeowners the need to keep detailed records of improvements to the home will no longer be needed.

However, gains larger than those excluded amounts are treated as taxable capital gains. Unlike the prior rules, there is no ability to simply reinvest the sales proceeds into a new home in order to defer the gain. Also, the special exclusion that was available for an individual age 55 or older no longer applies, although these new exclusion amounts apply to all taxpayers regardless of age.

QUALIFYING FOR THE GAIN EXCLUSION

Certain ownership and use tests must be met in order to qualify for this exclusion:

- The gain may only be excluded if, during the five-year period that ends on the date of the sale, the individual owned and used the property as a principal residence for a total of two years or more (known as the 2-out-of-5 rule). Short temporary absences for vacations or seasonal absences are counted as periods of use, even if the property is rented during these periods.
- For a married couple filing jointly, only one spouse must meet the ownership requirement; however, each spouse must meet the residency requirement individually to qualify for the full $500,000 exclusion.
- A widow or widower's period of ownership includes the period during which the deceased spouse owned the residence in determining the exclusion amount.
- If a residence is transferred to an individual as a result of divorce, the time that the former spouse owned the residence is added to the individual's period of ownership in determining the exclusion amount.

Failure to meet this 2-out-of-5 rule will generally result in the full gain on the home being considered taxable. However, an individual may be granted relief in some situations. These include when the home is sold due to a change in place of employment, health considerations, or other "unforeseen circumstances" as defined by the IRS. In these situations, a pro-rated exclusion can be granted.

LARGE GAINS CAN STILL BE TAXABLE

While these rules mean homeowners who sell their home for a modest gain have no real tax concerns, those who sell for larger gains will likely be required to pay some tax. Married couples who have a gain over $500,000 (or singles with a gain over $250,000) must report the excess as a taxable capital gain. This gain is taxed just like any other capital

gain, at either the long-term or short-term tax rates based on how long the home was owned. These gains can be offset with a capital losses, however.

In these cases, the best thing a home seller can do is make sure their cost basis is as accurate as possible by including costs associated with the purchase and maintenance of the home, thereby reducing any gain realized when sold. In establishing your adjusted cost basis in your home, it's important to keep good records of certain expenditures. The IRS provides the following guidance on expenses that are included or excluded when computing the basis of a personal residence:

- Expenses that can be used to increase basis include the following:
  - Certain settlement fees and closing costs on the original purchase of the home, such as commissions, title fees, and attorney fees.
  - Improvements that add to the value of the home, prolong its useful life, or adapt it to new uses. The cost of these improvements, including labor and materials, can be included in the basis in the property. Examples include:
    - Additions such as a bedroom, bathroom, deck, garage, porch or patio
    - Insulation, flooring/carpeting, plumbing and piping
    - Heating and cooling, filtration, irrigation and security systems
    - Exterior improvements such as storm windows/doors, roof, or siding
    - Landscaping, pavers, fence, retaining wall or swimming pool
    - Certain built-in appliances
- Expenses that can not be used to increase basis include the following:
  - Repairs and maintenance costs that do not add value, prolong the useful life, or adapt the home to new uses. This includes painting, fixing leaks or replacing a broken window or hardware. However, if these repairs are part of extensive remodeling or restoration (such as replacing all the windows or remodeling a kitchen) then they can be included in basis.
  - Improvements that are no longer part of the home, such as carpeting that was installed but later replaced.
  - Improvements that have a life expectancy of less than 1 year.

OTHER SCENARIOS

- <u>Death of a spouse</u> – If a widowed homeowner sells their home and meets the 2-out-of-5 years requirement, they may be eligible to use the full $500,000 exclusion rather than just the $250,000. This would apply if the surviving spouse sells the home within 2 years of the death and has not remarried at the time of the sale. The surviving spouse may also receive a basis adjustment for the deceased owner's share of the home, which may bring the total gain below the exemption.
- <u>Two homeowners getting married</u> – If two individuals each own a home, then get married and immediately sell both homes and purchase a third home, each seller will be limited to the $250,000 exclusion on their own gain. The larger exclusion is only available when both spouses have used the same home as a primary residence. They could sell one home immediately and exclude $250,000 of gain, then live in the other home. After at least two years, that home could then be sold and qualify for the full $500,000 exclusion.

For more information on the capital gains exclusion and calculating basis, see IRS Publication 523, Selling Your Home (www.irs.gov/pub/irs-pdf/p523.pdf) and Publication 551, Basis of Assets (www.irs.gov/pub/irs-pdf/p551.pdf).