



THE GREAT HOMEOWNERS TAX BREAK

A full explanation of the tax exclusion on the sale of a principal residence

If you currently own a home or plan to purchase one you will be overjoyed to learn about the great tax break Uncle Sam has especially for you as a homeowner. When you sell your principal residence the capital gain on the sale, up to \$250,000 or \$500,000, will be **excluded** from your income if you meet the **use** and **ownership** tests. These rules are established in IRC Section 121 and related regulations.

USE TEST

As the taxpayer you have lived in the property for at least two years (a total of 730 days) during the past five year period from the date of settlement when you purchased the property. Short temporary absences, such as vacations, are counted as periods of use.

OWNERSHIP TEST

You as the taxpayer or your spouse have owned the home for two years during the past five year period. The ownership and use test can be met during different two year periods. However, both tests must be met during the five year period ending on the date of settlement for the sale of your principal residence.

An **exception** to the ownership test is that if you received the property in a 1031 exchange it must be **owned for five years**. Section 1.121(d)(10) was added by Congress in October 2004 and created a five year ownership requirement if the principal residence was received in a IRC 1031 like-kind exchange. Exclusion of gain will not be allowed if the principal residence being sold was converted from a business or rental property received in a like-kind exchange and the property has not been owned for five years prior to the date of sale.

Excluding Up to \$500,000 of Gain. You can exclude up to \$500,000 of gain if **all** of the following are true:

- a) you are married and file a joint return for the year of sale;
- b) either spouse meets the two-year **ownership** test;
- c) both spouses meet the two-year **use** test; and
- d) during the past two year period, neither spouse excluded gain from the sale of another home.

A surviving spouse may exclude up to \$500,000 of gain if the property is sold in the same year that the other spouse died.

It is important to recognize that the **gain is excluded** – not deferred – and you do not have to purchase a replacement property. You may even convert one of your rental properties into your new principal residence and start a new two year period.

Gain Not Excluded.

a) Gain not excluded is any **depreciation** taken on the property after May 6, 1997. For instance if the house was rented, the Section 1250 depreciation will be recaptured and be taxed at 25%.

b) The taxpayer may not exclude the maximum amount of gain if during the previous two year period he or she sold another home and excluded all or part of that gain (see Reduced Maximum Exclusion of Gain below).

c) Any portion of the gain from property (separate from the dwelling unit) not used for residential purposes may not be excluded under Section 121 (example: farm property). The portion of the property used for business or investment purposes may be exchanged and the tax deferred under Section 1031.

However, other than the recapture of depreciation taken, gain on non-residential use within a dwelling unit may be excluded (example: a home office within the dwelling unit).

To determine the gain allocable to the residential and non-residential portions of the property, the taxpayer must allocate the basis and amount of gain realized using the same method of allocation used to determine depreciation adjustments (see Regulation Section 1.121-1(e) for complete examples).

Additional Rules. There are some additional rules which also favor the taxpayer. These are:

- a) If an adjoining vacant lot is sold within plus or minus two years of the settlement of the principal residence, then the combined gain on the residence and the lot may be excluded up to the maximum \$250,000 or \$500,000 allowed.
- b) In a divorce or separation, if part of the settlement, the ex-spouse owner not living in the property can claim it as his or her personal residence when the property is sold, provided the other spouse or former spouse is using the property as his or her principal residence.
- c) Residence in a licensed facility by a physically or mentally incapable person counts toward use after one year of living in the property being sold.
- d) If not remarried, a surviving spouse may use any period the deceased spouse owned and used the property as a principal residence before death.
- e) The taxpayer or spouse **does not** have to be living in the property at time of settlement to claim the exclusion. The property may be vacant or rented out.
- f) A taxpayer may exclude gain on the sale of a **partial interest**, if the partial interest sold includes an interest in the dwelling unit. Except for sales to a related party, the taxpayer may also apply the Section 121 exclusion rules when the remaining interest in the principal residence is sold.

Principal Residence Defined. Whether property is used by the taxpayer as the principal residence depends upon all the facts and circumstances. A principal residence may include a houseboat, a house trailer, or a co-op. If a taxpayer alternates between two properties, using each as a residence for successive periods of time, the property that the taxpayer uses a majority of the time during the year ordinarily will be considered the taxpayer's principal residence. In addition to the taxpayer's use of the property, relevant factors in determining a taxpayer's principal residence, include, but are not limited to—

(i) the taxpayer's place of employment; (ii) the principal place of abode of the taxpayer's family members; (iii) the address listed on the taxpayer's federal and state tax returns, driver's license, automobile registration, and voter registration card; (iv) the taxpayer's mailing address

for bills and correspondence; (v) the location of the taxpayer's banks; and (vi) the location of religious organizations and recreational clubs with which the taxpayer is affiliated.

Trust and Single Member Entity Ownership. If the taxpayer is the grantor of a trust, or a single member owner of a disregarded entity for federal tax purposes (such as an LLC) and the entity owns the property, the taxpayer will be considered the owner to satisfy the two year ownership requirements.

Reduced Maximum Exclusion of Gain. If the use or ownership of the property is less than two years OR the taxpayer has excluded gain within the preceding two years, then the maximum amount of exclusion will be reduced if the primary reason for the sale is: **change in place of employment, health, or unforeseen circumstances.**

Place of Employment. If the primary reason for the sale is a change in **place of employment** of a “**qualified individual**”, then a reduced exclusion may be claimed if employment is (1) with the same or a different employer, or (2) is new or the same self employment. The new place of employment must be 50 miles further from the residence sold than was the previous place of employment, or at least 50 miles if “qualified individual” is unemployed. See IRS Regulation Section 1.121-3(c).

Health. A reduced exclusion may be claimed if the **health** of a “qualified individual” is the primary reason for the sale. Health reasons include the need to obtain, provide for, or facilitate treatment of a “qualified individual” or if a physician recommends change of residence for health reasons. See IRS Regulation Section 1.121-3(d).

Unforeseen Circumstances. A sale is by reason of unforeseen circumstances if during the period of ownership and use as a principal residence the primary reason for the sale is the occurrence of an event that the taxpayer could not have reasonably anticipated before purchasing and occupying the residence.

Unforeseen circumstances include the involuntary conversion (condemnation), or destruction of the residence; if involving a “qualified individual” – their death, loss of job if eligible for unemployment insurance, change in employment or self-employment if unable to pay housing costs, etc.; divorce or legal separation; or multiple births from the same pregnancy.

Qualified Individual. The regulations significantly expand the circumstances in which the taxpayer may be able to claim an exclusion of the gain on the sale of their principal residence by defining a “qualified individual” as **the taxpayer, spouse, co-owner, or a person who lives with the taxpayer.** In addition, if the primary reason for the sale is health, then certain family members are also qualified individuals, including a descendant of the taxpayer’s grandparent.

Computation of the Reduced Maximum Exclusion for Each Taxpayer. The amount of the exclusion that may be claimed is still very generous and for most homeowners will cover all of their capital gain.

The formula used is: Determine the **lesser** of the number of days owned, used as a primary residence, or the number of days between the date of sale (settlement or transfer) of a previous property for which the taxpayer excluded gain under Section 121 and the date of sale of the current property. Next, divide that number by 730 (the number of days in two years). This gives the percentage of days owned or used as a primary residence during the two year period. This percentage is then multiplied times \$250,000 to give the maximum dollar amount of exclusion per taxpayer.

Example: A single taxpayer had to move due to a job transfer after living in the house for 400 days.

Computation: 400 divided by 730 equals 55% times \$250,000 equals \$137,000.

Result: Up to \$137,000 of capital gain may be excluded from income.

Retroactive. Most provisions of the IRS regulations are retroactive to May 7, 1997. This is the date that IRC Section 121, Exclusion of Gain from Sale of Principal Residence, was effective. Thus if you have paid capital gains tax unnecessarily on the sale of a principal residence, you may file an amended income tax return and claim a refund. As always you should consult with your tax advisor.

A Single Property Can Qualify for Both 121 Exclusion and 1031 Deferral of Gain. IRS Revenue Procedure 2005-14, which was effective January 27, 2005, applies to taxpayers who exchange a single property that satisfies the requirements for both the exclusion of gain from the exchange of a principal residence under Section 121, **and** the non-recognition of gain from the exchange of like-kind property under Section 1031.

To qualify for the principal residence exclusion as explained above, the taxpayer must have owned and lived in the property for two of the last five years but does not have to live in the property at the time of the exchange.

To qualify for the §1031 like-kind exchange deferral of the gain, the taxpayer at the time of the exchange must be holding the property for rental, business or investment purposes, and the new replacement property must also be held for business, rental or investment purposes.

The Section 121 Exclusion is Taken First. Any Section 1250 depreciation taken on the property after May 6, 1997, must be recaptured and may not be excluded under Section 121. However, it may be deferred under Section 1031. Boot received (both cash and/or debt reduction) of up to \$250,000 is excluded under Section 121. Additional boot may become taxable income.

In addition to the exchange of a principal residence converted to a rental or business property, the revenue procedure provides guidance and examples for when on one property there are two structures -- one used as a principal residence and one for business purposes. It also addresses the exchange of a single structure used partly as a personal residence and partly for business purposes (such as for a home office).

The importance of this revenue procedure is that it clearly recognizes that the sale and exchange of a single property may qualify for both the exclusion of gain under §121 and the deferral of gain under §1031. For a copy of the Revenue Procedure 2005-14, go to www.irs.gov and search for I.R.B. 2005-7, February 14, 2005.

Suspension of Five-Year Period for Military and Foreign Service Personnel. The "Military Tax Relief Act of 2003" (H.R. 3365), dated November 11, 2003, amended IRC Section 121 to suspend for a maximum of ten years the running of the five-year period while the taxpayer or their spouse is "serving on qualified official extended duty as a member of the uniformed services or the Foreign Service." The term 'qualified official extended duty' means "any extended duty while serving at a duty station which is at least 50 miles from such property or while residing under Government orders in Government quarters." The term 'extended duty' means any period of active duty for a period in excess of 90 days or for an indefinite period.

Foreign Service and military personnel qualify for the exclusion of profits on their sale if they have owned and lived in the property for a period of two years over the last five years plus the period suspended while on “qualified extended official duty.” The property may currently be vacant or be a rental.

To implement the law IRS Regulation Section 1.121-5 was published August 16, 2004. It provides the following example:

Example. B purchases a house in Virginia in 2003 that he uses as his principal residence for 3 years. For 8 years, from 2006 through 2014, B serves on qualified official extended duty as a member of the Foreign Service of the United States in Brazil. In 2015 B sells the house. B did not use the house as his principal residence for 2 of the 5 years preceding the sale. Under section 121(d)(9) and this section, however, B may elect to suspend the running of the 5-year period of ownership and use during his 8-year period of service with the Foreign Service in Brazil. If B makes the election, the 8-year period is not counted in determining whether B used the house for 2 of the 5 years preceding the sale. Therefore, B may exclude the gain from the sale of the house under section 121.

If the owner qualifies, then profit from the sale of the house up to \$250,000 if single, or up to \$500,000 if married and filing a joint return, will be excluded from income. The only taxable income would be the recapture of depreciation taken on the house since May 6, 1997.

Reference. To get all of the details and some excellent worksheets to figure the Section 121 exclusion, go to IRS Publication 523 “Selling Your Home.” This publication is available at www.irs.gov.

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