Everything Homeowners Need to Know About the New $250,000 and $500,000 Home Sale Tax Exemption Rules

A Special Report From Real Estate Expert Bob Bruss

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It's difficult to get very exciting about income taxes – *except* when it comes to *saving YOUR tax dollars!* Admit it! No matter how wealthy you might be, you *love* to save money, don't you? Especially when we're talking about saving BIG MONEY – I'm talking about saving thousands of tax dollars – it becomes almost fun to learn how.

During 2004, Uncle Sam changed and clarified some of the rules for avoiding taxes when selling your principal residence. As recently as October 22, 2004, he toughened some rules. But he liberalized others.

Even if you think you "know it all," I'll bet you will discover at least one or two home sale tax savings benefits you don't know. Whether you are a homeowner who wants to sell without paying a huge capital gain tax, an investor who is planning an "exit strategy" to sell your profitable investment property without owing tax on your large capital gains, or a real estate sales agent who wants to help your clients avoid costly tax mistakes, the new 2004 principal residence sale tax law developments are important to you for saving tax dollars.

DON'T DEPEND ON YOUR TAX ADVISER FOR ACCURATE TAX ADVICE. As you probably are aware, I've had the pleasure of writing the nationally-syndicated "Real Estate Mailbag" question and answer newspaper column for over 30 years. A week never goes by without a reader writing or e-mailing me to the effect "My tax accountant (or CPA) told me…but you said the opposite. Who is right?" It's amazing how often the reader's tax adviser is clearly wrong!

This is shocking, especially when thousands of taxpayer dollars are involved. Even CPAs are often not up-to-date on current tax law, especially regarding tax-deferred exchanges. Ask any CPA to explain how a Starker tax-deferred exchange works. You will be amazed at the lack of tax competence. Here is a costly example involving a principal residence sale:

> **EXAMPLE:** The only court decision we have so far, interpreting the principal residence sale $250,000/$500,000 exemption rule of Internal Revenue Code 121, is the U.S. District Court decision in Guinan v. U.S., 2003-1 USTC 50475. The facts were the Guinans sold their Green Bay, Wisconsin home there they spent

> more time than at their Georgia and Arizona homes. According to their affidavit, during the prior five years they spent 847 days in their Wisconsin home, 563 days in the Georgia home, and 375 days at their Arizona home. When they sold the Wisconsin residence, they paid $45,009 capital gain tax on its sale! Later, they figured out this was really their principal residence so they were entitled to the $500,000 home sale tax exemption for a married couple, as allowed by Internal Revenue Code 121. They sued the IRS for a $45,009 tax refund! That's not a smart thing to do. The IRS put on a vigorous defense. Although the Guinans proved they spent the majority of their time at their Wisconsin home before its sale, had bank accounts nearby, and registered their car there, the U.S. District Court judge ruled it was not their primary residence because (1) they never filed income taxes from that Wisconsin address and (2) during the same time, they used the old (now repealed) Internal Revenue Code 1034 to "rollover" the sale profit from their Georgia home into their Arizona home. The judge denied the $45,009 capital gains tax refund. In my opinion, the Guinans had very strong arguments their Wisconsin home was their principal residence and they never should have paid the capital gain tax, as their tax adviser told them to do.

Whether you are a "know it all" or an income tax beginner, this special report has something of profitable interest for you. If the Guinans had even basic knowledge of Internal Revenue Code 121, they would have seen they qualified for the $250,000/$500,000 home sale tax exemption, primarily based on their residence occupancy time. *Instead, they relied on their tax adviser and foolishly paid the $45,009 capital gains tax without getting a second opinion.* As everybody who has ever tried to get a tax refund from the IRS for overpaid taxes knows, it is never easy getting a tax refund.

I learned that fact years ago when I took an H&R Block tax training course. *Enrolling in that course was one of the smartest things I ever did.* I highly recommend you take such a course, even if you never want to prepare income tax returns. Most H&R Block offices advertise these classes, usually in September, to recruit tax preparers for the next tax season. It's a boring but extremely profitable course. Maybe I just had a great "old geezer" instructor. He drilled into us the key questions to ask to learn which deductions apply to each taxpayer. Although I didn't accept the job offered after completion of the course, the class time spent was extremely profitable.

QUICK SUMMARY OF THE BASIC PRINCIPAL RESIDENCE SALE TAX EXEMPTION RULE. Way back in the last century, 1997 to be exact, Congress enacted the Internal Revenue Code 121 principal residence sale tax exemption up to $250,000 for a qualified single home seller and up to $500,000 for a qualified married couple who file a joint tax return in the year of the home sale.

To qualify, the home seller(s) must have owned and occupied their principal residence an "aggregate" two of the last five years before its sale. For a married couple, only one spouse need hold title, but to qualify for the $500,000 break both spouses must meet the two-year occupancy test. If two individuals, not married to each other, own a

home together, they must each meet the two out of last five years ownership and occupancy tests.

> **EXAMPLE:** Recently, I answered a question in my "Real Estate Mailbag" column from a homeowner who has more than $250,000 capital gain in his home if he decides to sell. He asked if he gets married with that increase his principal residence sale exemption to $500,000? The immediate answer is "no." However, after his new wife lives in his principal residence at least 24 months, presuming they file a joint tax return in the year of home sale, then up to $500,000 capital gains will be completely tax-free. He does not have to add her name to the title for her to qualify for the additional $250,000 exemption.

That's it! Isn't that a simple tax rule? But I *still* get letters and e-mails inquiring about the old "rollover residence replacement rule" and the "over 55 rule." Both of these old tax breaks were repealed in 1997! *There are no age rules to qualify for IRC 121.* Now let's take a closer look.

Occupancy need not be continuous. You can qualify for IRC 121 if you purchased your primary residence as recently as 24 months ago, presuming you occupied it since then. Many prospective home sellers *erroneously* think they must have owned their homes at least five years before qualifying for this great tax break. Wrong!

In fact, if you owned and occupied your primary residence the required two out of the last five years, you could rent your home to tenants for up to three years before losing your principal residence sale exemption eligibility.

> **EXAMPLE:** I was recently listening to my Realtor friend Ray Brown's excellent Saturday morning real estate talk show on KNBR-radio in San Francisco. He had a caller who asked about renting his principal residence for a few years before selling it (because he expects it to continue appreciating in market value after he moves out). Brown wisely emphasized that the caller can rent the house for up to three years after moving out and it is need not be the seller's principal residence at the time of the sale without losing the $250,000 tax break.

Special tax break for incapacitated homeowners. If a home seller is physically or mentally incapable of self-care, that individual is deemed to have used their home during the time they own their residence but live in a licensed care facility, such as a nursing home. However, the home seller must have owned and occupied their principal residence at least an aggregate 12 months during the five years before the home sale.

New Tax Benefit for Military and Foreign Service Personnel. The 2003 Military Family Tax Relief Act created a new special exception to the two-out-of-five year occupancy rule for uniformed and foreign service personnel on active duty.

These homeowners can now elect to ignore the five-year period (IRC 121(d)(9)) by not reporting their home sale gain if they owned and occupied their principal residence

at least TWO of the last TEN years before its sale. This election is retroactive to home sales made after May 6, 1997 if the tax year is still open for tax return amendment. However, this new tax break only applies to one residence sale.

Special tax rule for divorced and separated home sellers. Internal Revenue Code 1041 allows tax-free inter-spousal real estate title and other transfers during the marriage or as part of a divorce or legal separation.

The old pre-1997 tax law was extremely unfair to divorced or separated spouses when one spouse remained in the family home, often until the youngest child became 18 or 21, when the home was to be sold. The bad result was the non-resident spouse (usually the ex-husband) was disqualified from the home sale tax exemption benefits because he didn't meet the occupancy test.

But the Taxpayer Relief Act of 1997 changed that. Now, if one spouse or ex-spouse (the "in spouse") meets the two out of five year ownership and occupancy tests before selling the principal residence, the non-resident co-owner ex-spouse (the "out spouse") can also qualify for his or her half of the tax-free home sale profits up to $250,000 without meeting the occupancy test.

Tax break includes deferred capital gains from prior home sales. Often forgotten, IRC 121 tax exemption benefits include deferred capital gains from prior home sales under the old, now-repealed IRC 1034 "residence replacement rollover rule."

This pre-May 6, 1997 tax-deferral rule allowed principal residence sellers to defer tax on their profitable home sales if they bought a replacement principal residence of equal or greater cost within 24 months after the home sale. Remember that great tax rule? Too bad it was repealed. But the tax result was the adjusted cost basis of the replacement home was less than the purchase price by the amount of the deferred capital gain.

> **EXAMPLE:** Suppose before May 6, 1997 you sold your old home for $150,000 with a capital gain profit of $60,000. Within 24 months, you bought a qualifying rollover replacement principal residence costing $200,000. However, your adjusted cost basis is not $200,000. Instead, it is $200,000 *minus* your $60,000 deferred capital gain, or $140,000. When you sell your current principal residence, your adjusted cost basis in this example will be $140,000, plus the cost of any capital improvements you added, minus any depreciation you deducted for partial business use of your home.

NO LIMIT TO NUMBER OF USES – SERIAL HOME SELLERS. Equally important, IRC 121 can be used over and over again, without limit, but not more frequently than once every 24 months. Some savvy home buyers have even created a tax-free business by buying a fixer-upper house, living in it at least 24 months, meanwhile renovating it to increase its market value.

If you do this over and over, you will soon become known as a tax-free "serial home seller!" A single person can qualify for up to $250,000 tax-free profits, but a married couple (or two qualified unmarried co-owner residents) can qualify for up to $500,000 tax exempt profits every 24 months. The big drawback, however, is living in the home while it is being renovated!

TESTS FOR DETERMINING YOUR PRINCIPAL RESIDENCE. Your IRC 121 primary or principal residence (the IRS calls it your "main home") is not always clear-cut, especially if you own two (or more) homes where you divided your occupancy time.

IRS regulations say your principal residence is "the property that the taxpayer uses a majority of the time during the year will ordinarily be considered the taxpayer's principal residence." Short absences, such as for a vacation, count as occupancy time, such as spending two months in Europe. But a one-year absence from your home won't count as occupancy time (unless you meet the medical care exception explained earlier).

The latest IRS regulations also say "In addition to the taxpayer's use of the property, relevant facts in determining a taxpayer's principal residence include, but are not limited to the: (1) taxpayer's place of employment; (2) principal place of abode of the taxpayer's family members; (3) address listed on the taxpayer's federal and state income tax returns and driver's license, automobile registration, and voter registration card; (4) location of the taxpayer's banks; and (5) location of religious organizations and recreational clubs with which the taxpayer is affiliated."

A major drawback of these IRS regulations is they might indicate a taxpayer's principal residence is at one home, but the taxpayer spends the majority of time at the other home.

> **EXAMPLE:** Suppose a retired couple spends seven months of each year in their Minnesota condo and five months at their Florida home. The Minnesota home looks like their principal residence based on the majority of time test. However, if the couple files their income tax returns from Florida (which has no state income tax), vote in Florida, have a Florida homestead exemption, have their auto and driver's licenses in Florida, and have their bank accounts with a Florida bank, now it looks like the Florida residence is their principal residence. Based on the minimum 24-month occupancy test within the fast five years before sale, either home meets that test.

PRINCIPAL RESIDENCE SALE EXEMPTION CAN INCLUDE PROFIT FROM THE SALE OF AN ADJOINING VACANT LOT. If you separately sell a vacant lot next to your principal residence, and if you sell it *within two years before or after* selling your principal residence, the lot sale capital gain can be included with the home sale tax exemption. Of course, if you sell the lot to the buyer of your principal residence, the lot sale profit also clearly qualifies for the exemption.

However this lot sale exemption only includes a "reasonable amount" of land adjoining your primary residence. This tax exemption cannot be used, for example, to make a tax-free farm sale just because the farm adjoins your home. Only the market value of the residence plus a reasonable amount of adjoining land can qualify.

NO ALLOCATION OF BASIS IS REQUIRED FOR HOME BUSINESS USE UNLESS THAT BUSINESS OPERATES FROM A SEPARATE BUILDING. If you operate a home business from your residence, when selling that property it used to be necessary to, in essence, make two sales – one of your principal residence and the other of your "business area." Fortunately, that is no longer necessary.

Tax advisers used to even suggest that you not claim any home business tax deductions for at least two years before selling your home – again, that is no longer necessary *unless your home business is operated from a separate building on your residence property.* Then an allocation to the value of the business building is required.

However, home sellers who claimed depreciation deductions for the business area of their residence after May 6, 1997 (the effective date of IRC 121) will have that depreciation "recaptured" (that means taxed!) upon home sale at a special 25% federal depreciation recapture tax rate. *Home business depreciation deducted before that date is not recaptured and is taxed as long term capital gain, subject to the $250,000 or $500,000 exemption.*

IF YOU OWNED AND/OR OCCUPIED YOUR PRINCIPAL RESIDENCE *LESS* THAN 24 MONTHS WITHIN THE FIVE YEARS BEFORE ITS SALE, YOU MAY BE ENTITLED TO A PARTIAL $250,000 OR $500,000 EXEMPTION. Internal Revenue Code 121 pas passed by Congress in 1997 included three provisions for partial use of the $250,000/$500,000 exemptions: (1) change of employment location qualifying for the moving expense deduction, (2) health reasons, and (3) unforeseen circumstances. Those first two exceptions didn't cause much confusion. But the third exception, even after clarifying the new IRS regulations, still causes confusion. Let's take a look at each exception:

Change of employment location. If the home seller qualifies for the moving expense tax deduction, then that seller can also qualify for a partial IRC 121 exemption if the principal residence was owned and/or occupied less than the required 24 months during the five years before the home sale. Briefly, the moving expense deduction requires the taxpayer's new work location to be at least 50 miles further from the old principal residence than was the old work site.

> **EXAMPLE:** Suppose your old principal residence was four miles from your old job location. You then changed job locations (whether with the same employer, a new employer, or you became self-employed doesn't matter). To qualify for the residential moving cost tax deduction, you new job location must be at least 50 miles *further* from your old home than was your old job site. In this example, that means your new work location would have to be at least 54 miles (4 + 50) to

qualify. If you meet this test, you then also can claim the partial home sale tax exemption.

The moving cost tax deduction also has work time tests, such as remaining employed at least 39 weeks during the year after the move in the vicinity of the new job location. For self-employed individuals, the minimum qualifying work time test is 78 weeks during the 104 weeks after the job location change. Either spouse can qualify, but "tacking" work time of one spouse unto another spouse's work time is not allowed.

Health reasons. Just because you think you will feel better living in Arizona rather than Alaska is *not* a sufficient health reason for selling your Alaska home and claiming a partial IRC 121 tax exemption! Qualified health reasons must usually be based on a physician's recommendation to the homeowner or a family member.

Health purposes can include (1) to obtain, provide, or facilitate the diagnosis, cure, mitigation, or treatment of disease, illness, or injury of a qualified individual, and (2) need to move to care for a family member. But a home sale which is merely beneficial to the general health or well-being of the individual does not qualify for the partial exemption.

Unforeseen circumstances. IRS regulations now include several "safe harbor" principal residence sale reasons which the IRS will not challenge. The first five reasons must involve the taxpayer, spouse, co-owner, or member of the taxpayer's household. In addition, the IRS Commissioner has authority to approve a partial exemption for other unforeseen circumstances. The "safe harbor" unforeseen circumstances are:

(1) Death in the immediate family; (2) divorce or legal separation; (3) becoming eligible for unemployment compensation; (4) change in employment leaving the taxpayer unable to pay the mortgage or reasonable basic living expenses; (5) multiple births resulting from the same pregnancy; (6) damage to the residence from a natural or man-made disaster, or an act of war or terrorism; and (7) condemnation, seizure or other involuntary conversion of the property.

If you qualify, calculate the partial IRC 121 $250,000 or $500,000 percentage exemption based on your number of months of occupancy. If you qualify for a partial exemption, as explained above, it's easy to calculate your percentage exemption. The denominator of the fraction will always be 24 (months). The numerator will be the number of months you occupied your principal residence before moving out for one of the above reasons.

EXAMPLE: Suppose you owned and lived in your principal residence for 16 months before receiving a job location transfer notice from your employer which qualifies for the moving expense tax deduction. Your fraction will be 16/24 or 2/3 which is 66.7% of the $250,000 or $500,000 exemption for which you are otherwise qualified. In this example, you therefore can claim up to $166,750 or

$333,500 tax-free home sale profit, depending on whether you are single or married, meeting the partial occupancy time test.

HOW TO AVOID TAX IF YOUR PRINCIPAL RESIDENCE SALE PROFIT EXCEEDS THE $250,000 OR $500,000 EXEMPTION. Thanks to the tremendous principal residence market value appreciation rates in the last few years, estimated at a national average of almost 10% for 2004, many home sellers have a nice problem that their capital gain will exceed their $250,000 or $500,000 exemption. Currently, that means their excess capital gain will be taxed at a maximum 15% federal tax rate, plus the state capital gains tax rate.

Make an Internal Revenue Code 1031 tax-deferred exchange. Virtually the only way to avoid tax on the principal residence sale capital gain, when that gain exceeds the $250,000 or $500,000 exemption, is to make an IRC 1031 tax-deferred exchange. This requires several steps: (1) move out of your house or condo and rent it to tenants; (2) then sell it, and (3) use the sale proceeds to acquire another "like kind" rental property of equal or greater cost and equity.

> **EXAMPLE:** Suppose you are a single home seller with a potential capital gain of $350,000. You want to sell your principal residence and acquire a larger home. However, if you make an outright sale, you will owe about $15,000 federal capital gain tax on your $100,000 capital gain exceeding your $250,000 exemption. To avoid that $15,000 tax erosion (plus any state tax), you can make a tax-deferred exchange for the larger home you want to acquire. However, that acquired home must be a "like kind" rental property – you cannot immediately make it your principal residence. Most tax advisers suggest renting the acquired property at least six to 12 months (to show rental investment intent) before moving in to convert it to your personal residence. This situation is ideal for a so-called Starker tax-deferred exchange – details are in my special report "How to Exchange Your Way to Tax-Deferred Real Estate Wealth." Be sure to comply with the Starker exchange tax rules, such as having the sales proceeds held by a qualified third-party intermediary beyond your constructive receipt, designating the replacement property within 45 days after the sale, and completing the replacement property acquisition within 180 days.

An easy way to rent your home and line up a buyer at the same time is to advertise it for sale on a one-year lease-option. *There are always more lease-option buyers than sellers.* Details are in my special report "How to Profitably Use a Lease-Option to Buy or Sell Your Home or Investment Property."

NOTES ON CONVERTED RESIDENCES ACQUIRED IN A TAX-DEFERRED EXCHANGE AFTER OCTOBER 22, 2004. Many investors who want to dispose of their rental or business properties and use the sales proceeds to buy their ultimate "dream home" and/or avoid tax on the sale of their investment property, have been using IRC 1031 tax-deferred exchanges.

Of course, to qualify for a tax-deferred exchange, the acquired property must be used as a rental to rental intent at the time of the exchange. After six months to a year, the investor can ask the tenants to leave so the owner can convert the acquired residence into their personal home. *Such a conversion to personal use is not a taxable event because there has not been any sale.*

However, effective October 22, 2004, Internal Revenue Code 121 was amended to require such a converted personal residence which was acquired in a tax-deferred exchange to be held for five years (although only two years of owner-occupancy is required) before it can be sold and qualify for the $250,000 or $500,000 tax exemption.

This tax law change was made to prevent investors from selling their investment property, trading into a residential property, converting it to the owner's principal residence, and qualifying it for up to $500,000 tax-free sales profits after two years of owner-occupancy. Now such a transaction takes five years!

HOW TO AVOID TAX ON THE PROFITABLE SALE OF YOUR VACATION OR SECOND HOME WHICH IS NOT YOUR PRINCIPAL RESIDENCE. Because your vacation or second home doesn't qualify as your principal residence, the best way to avoid tax on its profitable sale is to convert it to a rental property before selling it. Then it can qualify for an IRC 1031(a)(3) Starker tax-deferred exchange, as explained earlier for principal residence sales where the profit exceeds the exemption amount. Please remember the acquired property in a tax-deferred exchange must be a rental at the time of acquisition, although it can later be converted tax-free into your personal residence after at least six to 12 months of rental.

OTHER IMPORTANT PRINCIPAL RESIDENCE SALE RULES. Additional issues frequently arise regarding principal residence sales.

1 – Principal residence sale in the year of a spouse's death. IRC 121(b)(2) says the $500,000 principal residence sale exclusion is available for the sale of the marital home if the sale closes in the tax year of a spouse's death. Although the IRS considered extending this time limit beyond the year of a spouse's death, it found there is no authority to do so without the approval of Congress. *The tax reason is a surviving spouse can only file a joint tax return with the deceased spouse for the tax year of that spouse's death, but not in future tax years after that.*

However, this is not such a "big deal" as many surviving spouses believe. If the surviving spouse inherits the deceased spouse's half of the home, the surviving spouse receives a new basis on that inherited 50% "stepped-up" to market value as of the date of the spouse's death. If the principal residence is in a community property state, the surviving spouse usually receives a new stepped-up basis on 100% of the home's entire market value on the date of death.

This stepped-up basis for the deceased spouse's interest in the home usually is far more important than the $500,000 principal residence sale tax exemption which is available only in the year of death when a joint income tax return can still be filed.

The only time the surviving spouse is usually hurt financially occurs if title to the residence was held in the name of the surviving spouse alone so there was nothing to inherit from the deceased spouse. Then the surviving spouse does not receive a new stepped-up basis because he or she already held full title.

2 – Holding title in a living trust doesn't change eligibility for the $250,000/$500,000 exemption. When title to a principal residence is held in a trust for the benefit of the trustor, such as a living trust which avoids probate costs and delays, the method of holding title is disregarded for purposes of IRC 121 tax exemptions. "The sale by the trust will be treated for federal income tax purposes as if made by the grantor," IRS regulations explain.

3 – Sale of a partial interest in a principal residence won't increase the exemption. At the time a qualified principal residence owner sells a partial interest in the home, such as a sale to a son or daughter, that sale can qualify for the $250,000 or $500,000 exemption.

But this is not a tax loophole to allow the seller one exemption for a partial sale now and another exemption in the future when selling another partial interest. The IRS regulations clearly state that the maximum $250,000/$500,000 exemptions cannot be exceeded when selling partial interests in the seller's principal residence.

4 – Exempt principal residence sales need not be reported to the IRS. The IRS regulations state "Reporting of an excluded gain is unnecessary and would be unduly burdensome for taxpayers."

However, if your principal residence sale is partially taxable, such as when your capital gain exceeds the $250,000 or $500,000 exemption, your home sale should be reported on Schedule D of your federal income tax returns, clearly showing the exclusion amount.

SUMMARY. The $250,000 and $500,000 principal residence sale capital gain exclusions are major tax benefits for home sellers who understand how to maximize their exemptions. More details can be found in the IRS Regulations at IR-2002-142, available on the IRS website at www.irs.gov/newsroom with a link to the IR regulations as published in the Federal Register.

Additional information and details are available in the ***2005 U.S. Master Tax Guide*** (Commerce Clearing House, Chicago), ***J.K. Lasser's Your Income Tax 2005*** (John Wiley and Sons, Hoboken, NJ), and ***J.K. Lasser's Homeowner's Tax Breaks, 2005 Edition*** by Gerald J. Robinson, Esq. (John Wiley and Sons, Hoboken, NJ). These up-to-

date books are available in stock or by special order at local bookstores, public libraries, and www.amazon.com.

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