Legal Assistance Practice Points: Part 2: Calculating the Gain for the Sale of a Home

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In the last issue, I introduced the concern about tax liability for the sale of a Home. This article will continue the topic by describing how one calculates the Gain on a Home.

As I stated in the previous article, the Internal Revenue Service (IRS)[1] permits individuals to exclude the Gain on a main home if they meet certain requirements. You may exclude up to $250,000 if single or $500,000 if married and filing a joint return of the Gain on the sale of your main home if: 1) you meet the Ownership Test (owned the home for at least 2 of the 5 years ending on the date of the sale); 2) you meet the Use Test (lived in the home as your main home for at least 2 years); <u>and</u> 3) during the 2 year period ending on the date of the sale, you did not exclude Gain from the sale of another home. The question is, how does someone calculate the Gain?

To calculate the Gain (or loss) on the sale of your main home, you must know the Selling Price, the Amount Realized and the Adjusted Basis. To calculate the Gain or loss, subtract the Adjusted Basis from the Amount Realized. The Selling Price is the total amount you receive for your home, including money, all mortgages, notes or debts assumed by the buyer as part of the sale and the fair market value of any other property or services you receive. The Amount Realized is calculated by subtracting selling expenses (commissions, advertising fees, legal costs and loan charges paid by the seller, such as loan placement fees or “points”) from the Selling Price.

Determining the Adjusted Basis is more complicated. Your basis in your Home is the costs you bought it for or built it or if inherited or received as a gift, either the fair market value (what it would have sold for on the open market at the time you received/inherited it) or the Adjusted Basis of the previous owner. If you made adjustments (increases or decreases) to your Home’s basis, the result is your Home’s Adjusted Basis. Increases are typically additions and other improvements that have a useful life of more than 1 year (e.g. adding a bathroom, finishing a basement, new plumbing, new roof, paving a driveway, an addition, new deck, new fence or new garage) special assessments for local improvements and amounts you spent to restore casualty-damaged property. Repairs, that maintain the Home in good condition but do not add to its value or prolong life, are not added to the cost basis (e.g. repairing leaks, replacing a broken window or repainting). You add the cost of additions and other improvements to the basis of your property. Decreases include discharges of qualified principal indebtedness, deductible casualty losses or insurance payments for casualty losses, certain energy property credits and depreciation allowed or allowable if the home was used for business or rental purposes (more on this next time). It is therefore critical that you keep records to prove the Adjusted Basis (proof of the Home’s purchase price and expenses, receipts for all improvements, etc.).[2] In cases of foreclosure, if the principal residence debt is discharged or forgiven after 2006 but before 2013, you may be able to exclude it from gross income (normally, a discharge of indebtedness is considered a benefit to the individual and is therefore treated as a form of income that is taxable). IRS Form 982 and the accompanying instructions are illustrative of the tax treatment for such indebtedness.

Thus, if you meet the Ownership and Use Tests and did not exclude the Gain on another home in the 2 years prior to the sale of the current Home, and the Gain is less than $250,000 if you are single or $500,000 if you are married and filing jointly, you can exclude the Gain and are not required to report it.[3]

Stay Tuned for how to handle the sale if the Home was used as a rental property in an upcoming issue.

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[1] Internal Revenue Service (IRS) Publication 17 (2008) was heavily consulted in the preparation of this article.

[2] Worksheet 1 of IRS Publication 523 (2008) on page 31 is very useful in helping you calculate the Adjusted Basis of a Home Sold.

[3] Worksheet 2 of IRS Publication 523 (2008) on page 32 is very useful in helping you calculate the Taxable Gain on the Sale of a Home.