OVERVIEW OF THE TAX CONSEQUENCES OF THE SALE OF A HOME

by Yosefi Seltzer, Legal Assistance Attorney

Most people view the sale of a home as the end of a chapter, whether relocating to another community, moving to a larger home or simplifying their lives by shedding themselves of the costs and repair responsibilities. The reality is, the sale of a home could reap a financial windfall or unleash a significant tax analysis headache, depending on how the home was used while it was owned.

According to the Internal Revenue Service (IRS), individuals can exclude the Gain on a main home if they meet certain requirements. If you qualify, you may exclude part or all of the Gain on the sale of your main home, meaning, you won't have to pay tax on the Gain. 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. "Main home" is defined as the home you live in most of the time and it can be a house, houseboat, mobile home, cooperative apartment or condominium. The 2 years of Ownership and Use during the 5 year period ending on the date of the sale do not have to be continuous nor do they have to occur at the same time: so as long as you can prove you lived in the property as your main home for either 24 full months or 730 days during the 5 year period ending on the date of the sale, you are able to claim the taxable Gain exclusion. To claim the maximum $500,000 exclusion of the Gain: 1) you must be married and file a joint return, 2) either you or your spouse must meet the Ownership Test, 3) both you and your spouse meet the Use Test, <u>and</u> 4) during the 2 year period ending on the date of the sale, neither you nor your spouse excluded Gain from the sale of another home. In separation and divorce situations, you are considered to have used the property as your main home during any period when: 1) you owned it, <u>and</u> 2) your spouse or former spouse is allowed to live in it under a divorce or separation instrument and uses it as his or her main home.

There are certain exceptions that will extend the 5 year time frame, most notably, service-members can choose to have the 5 year Test periods for Ownership and Use suspended during any period you or your spouse serve on "qualified official extended duty" as a member of the uniformed services. This means you may be able to meet the 2 year Test even if you did not actually live in your home for at least the required 2 years during the 5 year period ending on the date of the sale. Basically, this means as long as you meet the 2 year Use and Ownership Tests within any 5 year period, you can disregard the time spent away from the home due to military service. So if you lived in the house for 2.5 years, then lived for 6 years away from the home due to military service and subsequently sold the home, you can still exclude the Gain because you lived in the home for at least 2 of 5 years, ignoring the 6 years that you were away from the home as a result of military service. The suspension period cannot last more than 10 years and together, the 10 year suspension period and the 5 year Test period cannot exceed 15 years.

CALCULATING THE GAIN FOR THE SALE OF A HOME

by Yosefi Seltzer, Legal Assistance Attorney

The Internal Revenue Service (IRS) 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, which 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.). Worksheet 1 of IRS Publication 523 (2008) on page 31 is very useful in helping you calculate the Adjusted Basis of a Home Sold. 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. 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.

HOW TO HANDLE THE SALE OF A HOME THAT WAS PREVIOUSLY A RENTAL PROPERTY

by Yosefi Seltzer, Legal Assistance Attorney

This article describes how the Sale of a Home is handled when it was previously a rental property. This topic is particularly relevant to military families who frequently relocate and decide to rent out their houses while they are stationed elsewhere.

The Internal Revenue Service (IRS) permits individuals to exclude the Gain on a main home if it meets 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. Now that we have covered the basics, it makes sense to discuss the different manner in which a Home that was a rental property under the same owner is handled.

You may still be able to exclude Gain from the sale of a Home that was used for business or as a rental property but the Ownership and Use Tests must still be met. If the Ownership and Use Tests are not met, even while attempting to utilize the military suspension discussed in the previous article, the Gain cannot be excluded and is therefore completely taxable and must be reported on the tax return for the year in which the house was sold. If the Ownership and Use Tests are met, you can still exclude Gain up to $250,000 if you are single or $500,000 if you are married filing jointly but you cannot exclude the part of the Gain equal to the Depreciation claimed during the years the property was rented or could have been rented. **Depreciation is a highly complex matter**, but basically, it means you recover the cost of income producing property through yearly tax deductions by depreciating or deducting some of the cost on the tax return each year. Consult IRS Publication 527 for more information regarding depreciation and treatment of residential rental property. You can deduct Depreciation only on the part of your property used for rental purposes. You should claim the proper Depreciation amount each tax year because even if you did not, you must still reduce your basis in the property by the full amount of Depreciation you could have deducted.

If you were entitled to take Depreciation deductions because you used the Home for business or rental purposes, you cannot exclude the part of the Gain equal to the depreciation allowed or allowable as a deduction for periods after May 6, 1997. For example, if you owned and used a house as your Main Home from 2002 through 2005 and on January 1, 2006, moved to another state and rented the house from then until April 30, 2008 when you sold it, you owned and lived in the house for 32 months (more than 2 years) during the 5 year period ending in the date of the sale. However, because the house was a rental property during your ownership, you must report the sale on an IRS Form 4797. Because you met the Ownership and Use Tests, you can exclude the Gain of up to $250,000 ($500,000 if married filing jointly), but you cannot exclude the Gain equal to the depreciation you claimed or could have claimed for renting the house.

As you can see, the Sale of a Home can become complicated, in particular, if the Home was used as a rental property. This is an area of tax law where individuals routinely make mistakes in failing to adjust the basis, report depreciation or determine whether the Ownership and Use Tests are met. If you are planning to sell a home or sold one during the current tax year, feel free to contact our office to request assistance or consult commercial tax preparation professionals. Please be advised that the Office of Legal Assistance is prohibited from providing legal advice and assistance for business activities, in accordance with Army Regulation 27-3, paragraph 3-8(a)(2). If your activities meet this definition, the Office of Legal Assistance will refer you to outside tax preparation professionals.