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SALE OF A RESIDENCE – WHAT ARE THE CURRENT RULES?

The IRS issued final regulations on the exclusion of gain from the sale of a principal residence under Section 121 on December 23, 2002.

Under the new home-sale exclusion rule, you may be able to exclude a portion, or possibly all, of the gain realized from the sale of your home if your home met the principal residence rules. During the five-year period, ending on the date of the sale you must have owned and used the property as your principal residence for a period aggregating two or more years. You need not have lived there continuously to qualify. You may use the exclusion as many times as you wish, provided the eligibility requirements are met, but generally no more frequently than once every two years.

The amount of the exclusion is generally limited to $250,000 for single individuals and married individuals filing separately. The exclusion is increased to $500,000 in the case of married couples filing a joint return, where at least one spouse meets the ownership requirement, both spouses meet the use requirement, and neither spouse is ineligible for the benefits because he or she excluded gain on the sale or exchange of a home under the new provision within the past two years. If a taxpayer marries someone who is ineligible, the taxpayer generally remains eligible for a maximum exclusion of $250,000.

If you fail to meet the ownership and use requirements due to a change in place of employment, health, or other unforeseen circumstances, you may exclude a fraction of the $250,000 ($500,000) amount.

Special rules apply in determining ownership and use if you are receiving out-of-residence care, inheriting property from a spouse, transferring property pursuant to a divorce, or disposing of property where the rollover rules applied.

The new exclusion rule also generally applies to the sale of a remainder interest in a principal residence, if all the other requirements are met. Thus, you may retain a life estate in your home while selling the remainder interest.

The new exclusion rule requires gain recognition to the extent of any depreciation taken after May 6, 1997, for the rental or business use of your home. In such cases, the gain will be subject to a special capital gain rate of no greater than 25%.

The home-sale gain exclusion provision generally applies to sales of a principal residence occurring after May 6, 1997. You may elect, however, not to have the new exclusion provision apply to any sale or exchange (in such cases, gain recognition generally is required, and the prior law rollover and one-time exclusion provisions cannot be applied).

With the repeal of the rollover rule, you are no longer required to purchase a replacement residence within strict time limits in order to defer (rollover) any gain realized on the sale or exchange of your home. Also, the present exclusion rule is a significant improvement over the once-in-a lifetime over-age-55 exclusion, not only because it is available to taxpayers of all ages and allows a greater exclusion, but because it can be used repeatedly and one spouse is not denied the benefit of the exclusion just because the other spouse had elected to exclude gain on the prior sale of another residence.

There is a downside to the repeal of the rollover rule if you have a gain in excess of $250,000 ($500,000 if married filing jointly) when you sell your home. Instead of being able to defer the gain by buying a more expensive home, as under prior law, you will now be liable for income tax on the excess gain in the year of sale.

Reduced Maximum Home-Sale Gain Exclusion in Certain Situations

Remember that the general rule is that homeowners may exclude from their gross income up to $250,000 ($500,00 for married filing jointly) of the gain from the sale of their home. This general rule applies to homeowners that have owned and used their home for two out of the last five years.

Homeowners may still exclude a portion of the gain from the sale of their home if the primary reason for the sale of the home is one of the following: (1) a change in the place of employment; (2) health reasons; or (3) unforeseen circumstances. These reasons, and the requirements for each, are discussed more fully below.

Change in the Place of Employment

If you or your spouse, a co-owner of the residence, or a person whose main home is the same as yours, is changing his or her place of employment, then you may be permitted to exclude a portion of the gain from the sale of your home from your gross income. A change in the place of employment can be starting work with a new employer, starting self-employment, continuing to work for your current employer in a new location, or continuing self-employment in a new location. The change in place of employment must have occurred while you owned and used the property as your personal residence, and the new place of employment should be at least 50 miles from your home than the previous of employment (or from your home if the individual was unemployed).

Health Reasons

You may be permitted to exclude a portion of the gain from the sale of your home from your gross income, if the primary reason for selling your principal residence is the health of one of the following individuals:

- Yourself;
- Your spouse;
- A co-owner of the residence;
- A person whose main home is the same as yours;
- A parent, grandparent, stepmother or stepfather;
- A child, grandchild, stepchild or adopted child;
- A brother, sister, stepbrother, stepsister, half brother or half sister;
- A mother-in-law, father-in-law, brother-in-law, sister-in-law, son-in-law or daughter-in-law;
- An uncle, aunt, nephew or niece.

You are considered to be selling your home for health reasons if: (1) you are selling your home because of the necessity to obtain, provide or facilitate the diagnosis, cure, mitigation, or treatment of disease, illness, or injury of one of the individuals listed above, or to obtain or provide medical or personal care for one of the individuals listed above that is suffering from a disease, illness or injury; and

(2) a doctor recommends a change of residence for reasons of health. Selling your home because it is beneficial to a person's general health or well-being is not considered to be selling your home for health reasons.

Unforeseen Circumstances

You may be permitted to exclude a portion of the gain from the sale of your home from your gross income, if the primary reason for selling your principal residence is one of the following unforeseen circumstances:

- An involuntary conversion from your home.

- Natural or man-made disasters or acts of war or terrorism resulting in a casualty to your home, whether or not your loss is deductible.

- In the case of yourself, your spouse, a co-owner of the residence, or a person whose main home is the same as yours, one of the following occurs: (1) death; (2) unemployment (if eligible for unemployment compensation); (3) a change in employment or self-employment status that results in the inability to pay basic living expenses (such expenses are discussed more fully below); (4) divorce or legal separation; or (5) multiple births resulting from the same pregnancy.

- An event the IRS determines to be an unforeseen circumstance in its published guidance. Previous events the IRS has determined to be unforeseen circumstances include the September 11, 2001 terrorist attacks.

Reasonable basic living expenses, as mentioned above, include amounts spent for food and clothing, housing and related expenses, medical expenses, transportation expenses, tax payments, court ordered payments, and expenses reasonably necessary to produce income.

If the primary reason for selling your personal residence is any of the reasons listed above, you may exclude from your gross income a portion of the gain from the sale of your home. If the primary reason for selling your personal residence is not listed above, you may still qualify for the home-sale gain exclusion. Certain factors, listed below, will be considered in determining whether you may exclude from your gross income a portion of the gain from the sale of your home:

- Your financial inability to maintain your residence materially changed.

- The suitability of your property as a residence materially changed.

- The circumstances causing the sale were not reasonably foreseeable when you began using the property as your principal residence.

- During the time you owned the property, you used it as your residence.

- The circumstances causing the sale occurred during the time that you owned and used the property as your personal residence.

- The sale and the circumstances causing the sale were close in time.

The new rules provide for a larger benefit to most taxpayers but they can be complicated. We have provided this as a summary of the rules and this is not intended to provide specific tax advice for your particular situation. Contact us for more information on your particular situation.