Taxes When You Sell Your Home
By Bill Bischoff

IF YOU'RE A HOMEOWNER, then you're probably aware of the incredibly generous tax break available when you sell your home. Play your cards right and you can lock in a profit of up to $250,000 ($500,000 when you file jointly) and owe *nothing* to the IRS.

This great deal was enacted in 1997 and came with a couple of caveats. It stated that you must have owned and used the property as your primary residence for at least two years out of the five-year period ending on the sale date. The gain-exclusion privilege was also generally unavailable if you excluded an earlier gain within the two-year period ending on the sale date. In other words, it required a 24-month waiting period before you deleted another home-sale gain from your 1040.

Fair enough.

But there was a discomforting lack of IRS guidance about how to apply these seemingly simple rules to various real-life situations. For example: What happened if you sold your home after owning it for *less* than two years? Thankfully, the IRS finally released a long-awaited batch of regulations in 2002. And they turned out to be worth the wait, because they're surprisingly taxpayer-friendly.

You Don't Meet the Two-Year Rules
So what happens when you fail to meet the basic home-sale timing requirements described above? For example, say you sold your home for a profit after living there for only 18 months instead of the required two years. Or you might sell your current home less than two years after excluding a gain from the sale of a previous residence. Must you pay tax on the entire gain when you make a "premature" sale?

Probably not. Odds are you can avoid any federal tax by claiming a reduced gain exclusion. (However if you're ineligible for this privilege, your entire profit will indeed be taxed.) Happily, the IRS rules make it pretty darned easy to qualify for the reduced gain-exclusion break. And if you qualify, it will almost certainly be big enough to shelter the entire gain from making a premature sale.

Assuming you're eligible, the reduced exclusion amount equals the full $250,000 or $500,000 figure (whichever applies to you) multiplied by a fraction. The numerator is the shorter of: (1) the aggregate period of time you owned and used the home as your principal residence during the five-year period ending on the sale date; or (2) the period between the last sale for which you claimed an exclusion and the sale date for the home currently being sold. The denominator is two years (or the equivalent in months or days).

Example 1: You and your spouse owned and used a home as your principal residence for 22 months. In this case, the reduced exclusion available to shelter your premature home-sale profit is $458,333 [$500,000 x (22 months/24 months)].

Example 2: You're unmarried. You sold your previous home 13 months ago and excluded the gain. Now you're about to sell your current home, which has been owned and used as your principal residence for 18 months. (You bought it and occupied it for five months before finally succeeding in selling your previous home.) The reduced exclusion available to shelter gain from prematurely selling your current home is $135,417 [$250,000 x (13 months/24 months)].

So when does the reduced exclusion apply? When the premature sale is primarily due to: (1) a change of place of employment; (2) health reasons; or (3) other unforeseen circumstances. The IRS regulations provide favorable rules that you can rely on. Here's how each scenario is defined.

Premature Sale Due to Change in Place of Employment
If any "qualified individual" experiences a change in place of employment, you can say that was the primary reason for your premature home sale, making you eligible for the reduced-gain exclusion. "Qualified individual" means you, your spouse, any co-owner of the home or any other person whose main residence is within your household.

A premature home sale will automatically be considered as primarily due to a change in place of employment if any qualified individual passes the following distance test: the new place of employment or self-employment must be at least 50 miles farther away from the former residence (the property that's sold) than was the former place of employment or self-employment from the former residence.

There can be exceptions to the 50-mile test. You'll still be eligible for the reduced gain-exclusion break if specific circumstances show your premature home sale was primarily due to a qualified individual's change in place of employment. If, for example, you get a new job as an emergency-room worker that requires that you live nearby, you could still be eligible for the reduced-gain exclusion.

Premature Sale Due to Health Reasons
Under the regulations, a premature sale of your home was primarily due to health reasons if you must move in order to: (1) obtain, provide or facilitate the diagnosis, cure, mitigation or treatment of disease, illness or injury of a qualified individual; or (2) obtain or provide medical or personal care for a qualified individual who suffers from a disease, illness or injury.

For this purpose, "qualified individual" means: you, your spouse, any co-owner of the home or any person whose principal residence is within your household. In addition, almost any close relative (including siblings and step-children) of a person listed above also counts as a qualified individual. And any descendent of your grandparent (such as your first cousin) counts as a qualified individual, too.

A premature home sale will automatically be considered primarily for health reasons when a doctor recommends a change of residence for reasons of a qualified individual's health (as explained above). Otherwise, the facts and circumstances must indicate your premature sale was primarily for reasons of a qualified individual's health.

Premature Sale Due to Unforeseen Circumstances
The regulations also allow you to say your premature home sale was primarily due to unforeseen

circumstances when any of the following events occur during the period of your ownership and use of a property as your principal residence:

- a qualified individual dies;
- a qualified individual becomes eligible for unemployment compensation;
- a qualified individual experiences a change in employment status or self-employment status that results in your inability to pay housing costs and basic living expenses;
- a qualified individual is divorced or legally separated;
- a qualified individual's pregnancy results in multiple births;
- your residence is sold after being seized or condemned (such as by a government agency);
- your residence is a casualty of a man-made disaster or act of war or terrorism.

For this purpose, "qualified individual" means you, your spouse, any co-owner of the property or any other person whose principal residence is within your household.

If Your Home Is Used Partly for Business or Rental Purposes
If you have a home office for your small business or if you rent out rooms in your home (and have done so the entire time you've owned your home), the IRS rules have some favorable tax treatments.

You can treat your entire home as a single property, provided the residential part and the rental or business part are both within the same dwelling unit. So your entire home can qualify for the $250,000 or $500,000 gain exclusion, as long as you pass the tests explained at the beginning of this article for the residential part. One catch: You must pay tax on any gain attributable to depreciation deductions claimed for post-May 6, 1997, rental or business use of your home. But since you already reaped tax savings from those earlier depreciation write-offs, you still come out ahead.

Warning: The IRS regulations won't help when the rental or business portion of your property is *not* within the same dwelling unit as your residence. For example, say you use a detached building as a rental unit. When you sell your property, you must separately calculate any gain allocable to the detached building and pay tax on that figure. Ditto if the part of your home that you've rented out comprises a complete and separate dwelling unit because it has kitchen and bathroom facilities and a separate entrance.

If You Sell Vacant Land Next to Your House
The regulations also allow you to use your valuable gain exclusion to shelter profit from selling vacant land next to your principal residence. You can even sell the parcel with your home and the surrounding vacant land in completely separate transactions. However, the land must be sold within two years before or after you sell the parcel containing your house. Also, the land must be adjacent to that parcel and be used as part of your principal residence.

If you pass these tests, your gain exclusion can be used to offset up to $250,000 ($500,000 if you file jointly) of combined profits from selling the parcel containing your house and the adjacent vacant land. For instance, an example in the regulations says you can sell a one-acre parcel with your home in one transaction and a 29-acre adjacent parcel of vacant land in a separate transaction — and use your gain exclusion to shelter the combined profits from the two sales. Presumably, the same favorable result would apply if you sold your vacant land in several separate transactions.

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Attn: Customer Service
250 West 55th Street
10th Floor
New York, NY 10019