Bob's Notebook

RECENT CHANGES TO THE $250,000 HOME-SALE TAX EXEMPTION

2005 Realty Tax Tips: Do I qualify?

2004 was a record year for home market value appreciation in most communities. The national average is reportedly around 10 percent, with the spectacular exception of 40 percent appreciation for Las Vegas homes, according to several reliable estimates. Final statistics aren't available yet, but the past 12 months have been extremely profitable for most house and condo owners.

Virtually all homeowners, if they decide to sell, have the very profitable situation of being able to walk away with up to $250,000 (up to $500,000 for a qualified married couple) tax-free principal residence sale capital gain profits.

THE SIMPLE QUALIFICATION TAX RULES. To qualify for Uncle Sam's generous principal residence sale tax exemption rules, Internal Revenue Code 121 requires the home to have been owned and occupied by the seller(s) at least an "aggregate" 24 of the 60 months before the sale.

There is no limit to the number of uses of the IRC 121 exemption. However, it cannot be used more frequently than every 24 months (with limited exceptions for partial exemptions explained below).

The occupancy time need not be continuous. For example, if you occupied your home for 12 months after its purchase, and then you rented it for two years before moving back in a year ago, you meet the two out of last five years occupancy test. If just one spouse meets the test, then only a $250,000 exemption is available.

The method of holding title is irrelevant. Title can be in one spouse's name alone, or in both spouse's name. Or title can be held in a living trust, providing the ownership and occupancy tests are met.

There are no age restrictions. They were eliminated in 1997, as was the need to buy a replacement principal residence of equal or greater cost.

If the home seller is on active duty in the uniformed or foreign service, a new exception eliminates the five-year period if the principal residence seller owned and occupied their principal residence at least two of the 10 years before its sale.

WHAT IS YOUR PRINCIPAL RESIDENCE? About a year ago, the IRS imposed new regulations for determining your principal residence. These tests, in addition to the two out of last five years occupancy requirement, include (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; (4) location of the taxpayer's banks; and (5) location of civic affiliations, such as the taxpayer's religious organizations and recreational clubs.

The only court decision interpreting these criteria is *Guinan v. U.S.*, 2003-1 USTC 50475. In that case, the Guinans sold their Green Bay, Wisconsin home, where they spent more time than in their other homes. They paid the $45,009 capital gains tax. Later, they decided this was really their principal residence and they asked the IRS for a refund. The claim was denied. Then the Guinans sued. The U.S. District Court ruled the home sold was not their principal residence because they never filed their income tax returns from that address.

SALE OF A HOME IN THE TAX YEAR OF A SPOUSE'S DEATH. IRC 121(b)(2) allows full use of the $500,000 principal residence sale tax exemption in the tax year of a spouse's death. The IRS tried extending this time limit beyond the year of the spouse's death, but discovered it lacked Congressional authority to do so.

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.

However, when a surviving spouse inherits the deceased spouse's half of the home, the surviving spouse usually receives a new "stepped up basis" for at least 50 percent of the home's market value on the date of death. In community property states, the stepped-up basis is often 100 percent of market value. As a result, the surviving spouse usually has no significant tax problem when the home is sold.

SPECIAL TAX BREAK FOR DIVORCED AND SEPARATED HOME SELLERS. A little-known provision in IRC 121 says if one divorced or separated spouse (known as the "in spouse") qualifies for the $250,000 tax break, the other spouse (known as the "out spouse") can also qualify.

This is especially important when one spouse remained in the house, usually until the youngest child became 18 or 21, when the residence is sold. Now the non-resident co-owner spouse can also qualify for up to $250,000 tax-free home sale profits.

EXEMPTION CAN INCLUDE PROFIT FROM SALE OF AN ADJOINING LOT. When a home owner sells an adjoining vacant lot within two years before or after selling the principal residence, IRC 121 allows including the lot sale capital gain within the $250,000 or $500,000 tax exemption. However, this tax break only includes a "reasonable amount" of adjoining land and would not allow the tax-free sale of an adjoining farm.

PARTIAL EXEMPTION WHEN YOU DON'T MEET THE 24-MONTH TEST. When Congress enacted IRC 121 in 1997, it included three partial exemptions for less than the required 24 months of occupancy: (1) change of employment location qualifying for the moving expense tax deduction, (2) health reasons, and (3) unforeseen circumstances.

This partial exception means if a home seller doesn't meet the 24-month test, but sells due to one of the three approved reasons, the seller then qualifies for a partial exemption.

To illustrate, if you owned and lived in your principal residence 18 months before selling due to one of the reasons above, then 18/24 or 75 percent of your $250,000 exemption is available.

The change of employment location and health reasons home sale tests haven't caused problems.

But the "unforeseen circumstances" test is still evolving. The IRS "safe harbor" regulation includes (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.

HOW TO AVOID TAX IF YOUR SALE PROFIT EXCEEDS $250,000 OR $500,000. If your principal residence sale profit exceeds the $250,000 or $500,000 tax-free exemption, the only way to avoid tax on your home sale profit is to make an Internal Revenue Code 1031 tax-deferred exchange.

That means you must (1) move out of your principal residence and rent it to tenants, (2) then sell it, and (3) use the sale proceeds to acquire another rental property of equal or greater cost and equity. Be sure to comply with IRC 1031(a)(3), which requires designating the replacement rental property within 45 days and completing the acquisition within 180 days.

An easy way to accomplish this tax result is to sell your home on a one-year lease-option with a provision the option cannot be exercised sooner than six months. The acquired property must also be a rental; most tax advisers suggest waiting at least a year before converting it to owner-occupancy.

NEW EXCHANGE RULE APPLIES AFTER OCT. 22, 2004. Many investors who used an IRC 1034 tax-deferred exchange have traded their rental property into a luxury "dream home" where they eventually want to live. Their tax goal is to liquidate up to $250,000 (up to $500,000 for a qualified married couple) of tax-free profits from their investment rental property.

But on Oct. 22, 2004, President Bush signed a new tax law amending IRC 121 to require such a converted residence acquired in an exchange to be owned for at least five years, although owner-occupancy is required for only two of those five years.

SUMMARY: Internal Revenue Code 121 provides a superb tax-free exemption for home sellers who fully understand the rules. More details are available from your tax adviser and in the new Robert Bruss special report, "Everything Homeowners Need to Know About the New $250,000 and $500,000 Home Sale Tax Exemption Rules," available for $4 from Robert Bruss, 251 Park Road, Burlingame, CA 94010 or by credit card at 1-800-736-1736 or instant Internet download at www.bobbruss.com.