

Sale of Residence Exclusion

By: Richard M. Colombik, JD, CPA

A home is many times the largest asset that one owns. The rules for excluding the gain from the sale of a taxpayer's residence were drastically changed in the Taxpayer Relief Act of 1997. See, P.L. 105-34. The current law allows for a limited exclusion from recognizing taxation on the gain from the sale of a principal residence, but does not allow for the recognition or deduction if a loss is incurred. No loss is allowed as a residence is considered personal in nature, and losses are only allowed on the sale of capital assets, not personal assets. IRC §121.

The prior law had two provisions for gain exclusions, which have been repealed. One prior provision allowed for the rollover of a gain and the second prior rule was allowed for "seniors", over 55 year olds.

The current rule allows for a limited exclusion from the sale of a taxpayers "principal residence". The exclusion is for up to \$250,000 for individuals, but also allows for up to \$500,000 for married taxpayers who file a joint income tax return. IRC §121(b); Treas. Regs. §1.121-2(a). As many code sections, unfortunately the key term, "principal residence" is NOT defined. Treasury regulations direct a taxpayer to look at all facts and circumstances to determine what is a "principal residence". A further restriction also has a five year review period to determine a "principal residence". A taxpayer must use the real estate as their "principal residence" for a period aggregating two or more years within the five year period ending on the date the home was sold or exchanged.

The two of five year period is easier to comply with than many other provisions of this section. The usage periods, two of five do NOT need to be continuous. It is an aggregate usage of at least two of the last five years. See, IRC §121.

The exclusion is allowable every time a taxpayer meets their eligibility requirements, generally it can not be more than once every two years. Treas. Reg. §1.121-2(b). In the case of multiple sales a taxpayer may elect to opt out or not to use the exclusion. IRC §121(f).

What can qualify as a principal residence?

Court cases have indicated that a residence may mean different things to different people. For example, a house trailer, houseboat or even shares in a cooperative housing corporation qualify as a "principal residence". Lokan v. Comr., 1979 T.C.M. 380, *See also*, PLRs 9637031, 9649017. Even disregarded entity ownership, such as a grantor or land trust have been recognized to be imputed to the individual owners for purposes of taking the exclusion. Treas. Reg. §1.121-1(c)(3). This logic extends to any type of disregarded entity such as a single member LLC for exclusion as well as ownership.

The issue of determining what a principal residence is becomes more complex if a

taxpayer owns more than one home. Treasury regulations provide a "majority of the time" test to determine principal residence status. Treas. Reg. §1.121-1(b). The regulations have a list of factors to review to help in this analysis which include;

- Location of employment;
- Location of taxpayer's family;
- Taxpayers address for governmental registration, tax returns, voters card, drivers license, etc.
- Addresses for credit cards and other bills;
- Affiliations within the community, clubs, religious affiliation

To add a degree of confusion on multiple homes, the IRS allows short term or temporary absences to be disregarded, but will not issue rulings or determination letters addressing whether ones property qualifies as a taxpayers principal residence. Rev. Proc 2004-3, 2004-1 I.R.B. 114.

PROPORTIONATE RULES

Proportionate rules for part of the \$250,000 exclusion may also apply if one does not meet the two of five year rule, but does meet the principal residence test, if such move is due to a change in place of employment, health, or other unforeseen circumstances. The change due to employment, health or other "unforeseen" circumstances, must be the primary reason for the sale. A sale or exchange is due to unforeseen circumstances if the primary reason for the sale or exchange is the occurrence of an event that the taxpayer could not reasonably have anticipated before purchasing and occupying the residence. If this occurs talk to your tax advisor about whether you may qualify for the proportionate reduction rule!

Also remember if you use part of your home for business, the portion attributable to your business use does NOT qualify for the exclusion rules. The exclusion is reduced for any depreciation allowed or "allowable" regarding the business or rental usage of your home. If taxable a maximum capital gain rate of 25%, versus the 15% rate will apply to this share of your gain.

DOUBLE EXCLUSION RULES

The joint return, married spouse rule is also a bit tricky. Many rules must be complied with to obtain the benefit of the \$500,000 exclusion versus the normal \$250,000 rule. IRC §121(b)(2) and Treasury Regulation §1.121-2(a) list the following requisites:

- Tax Return- a joint return must be filed in the year of sale;
- Ownership Test- at least one spouse must qualify
- Use Test - both spouses must qualify; and

- Disqualification - neither spouse is ineligible due to using this provision during the two-year period ending on the date of the sale or exchange of the residence

If you meet the test, you may be able to exclude up to \$500,000 of gain from taxation!

CONCLUSION

The rules may be a bit tricky, but they can save you a lot of money on the sale of your "principal residence". A bit of planning on which property is your residence can go a long way towards keeping tax dollars in your pocket!