Questions and Answers for the New $500,000 Home Sale Exclusion

NATIONAL ASSOCIATION OF REALTORS®

The Voice for Real Estate®

New Tax Provisions Affect Sale of Your Principal Residence

The tax bill signed by the President on August 5, 1997, provides substantial benefits to taxpayers who sell their principal residence. The Q&As in this document are intended to provide basic guidance to agents, sellers and buyers on issues that are covered by the new federal statute. These Q&As are by no means exhaustive.

Please note that your individual state tax law might differ from the federal provisions discussed herein. The Internal Revenue Service will no doubt issue additional guidance over the coming months that will further clarify this new law.

As with all tax issues related to a transaction, guidance from a competent tax advisor is essential.

1. What is the new $500,000 exclusion?

This new exclusion replaces and greatly expands the old $125,000 one-time exclusion allowed for taxpayers who were age 55 or older. The amount has been increased to $500,000 for married taxpayers who file a joint return; the exclusion for taxpayers who do not file a joint return is $250,000. You now can claim this exclusion every two years, and you do not have to buy a new residence.

2. Do I have to be a certain age to claim this exclusion?

No. Under old law, you had to be age 55 before the date of sale in order to claim the $125,000 exclusion. The new exclusion does not impose any age restrictions, so any seller is eligible.

3. How do I qualify for this exclusion?

You must satisfy three tests, each of which contains a two-year requirement:

- Ownership Test;
- Use Test; and
- Waiting Period Test.

3A. *What is the Ownership Test?***

You must have owned the residence for periods aggregating at least two years of the five-year period ending on the date of sale.

3B. *What is the Use Test?***

You must have used the property as your principal residence for periods aggregating at least two years of the five-year period ending on the date of sale.

***SPECIAL NOTE: If the residence you are selling was acquired in a rollover transaction, you may be allowed to include the period of time you owned and used your former principal residence(s) for purposes of the Ownership and Use Tests. You should consult your tax advisor to determine if you qualify.*

3C. *What is the Waiting Period Test?*

You must not have utilized this exclusion for any sale during the preceding two-year period.

4. My spouse and I have not been married long enough to satisfy any of the two-year tests. Can we qualify for the full $500,000 exclusion?

Maybe, provided you file a joint return for the year of sale and satisfy the Ownership, Use and Waiting Period Test, each of which is slightly different for married taxpayers.

4A. *Ownership Test.***

Either you or your spouse must satisfy this test. So, you still can claim the exclusion even if only one of you owns your residence.

4B. *Use Test.***

Both you and your spouse must satisfy this test, so each of you must have used the property as your principal residence for two years of the five-year period ending on the date of sale.

***SPECIAL NOTE: If the residence you are selling was acquired in a rollover transaction, you may be allowed to include the period of time you owned and used your former principal residence(s) for purposes of the Ownership and Use Tests. You should consult your tax advisor to determine if you qualify.*

4C. ***Waiting Period Test.***

You cannot claim this exclusion if ***either*** you or your spouse sold a principal residence during the last two years that qualified for this exclusion.

5. Can we still claim the $500,000 exclusion even though my spouse does not have any ownership interest in and is not on the title of our principal residence?

Yes. The Ownership Test is satisfied if ***either*** you or your spouse owns the property for two of the five years ending on the date of sale. Of course, you also must satisfy the other requirements. The threshold requirement for claiming the $500,000 exclusion (as opposed to the $250,000 exclusion) is joint filing status, not joint ownership.

6. I have owned and lived in my residence for over five years. My spouse and I were married only last year, so she has lived in the residence for only a year. Can we claim the $500,000 exclusion even though she has not used this house as her principal residence for two of the last five years?

No. Both of you must meet the 2-year Use Test. There is no exception to this rule for newly-married couples.

7. Can I still claim the $250,000 exclusion even though my spouse does not satisfy the Use Test?

Yes. The law is written so that the exclusion is increased to $500,000 if a married couple files a joint return and satisfies all of the Ownership, Use, and Waiting Period Tests. If either of you fail the Use Test or the Waiting Period Test you cannot claim the $500,000 exclusion, but would qualify for the $250,000 exclusion. *(NOTE: As discussed above, only one of you need satisfy the Ownership Test.)*

8. I transferred ownership of my principal residence to my revocable living trust over five years ago, so technically, I do not satisfy the ownership test. Can I still claim this exclusion?

Maybe. The answer to this question really depends upon the terms of your living trust. The typical "living trust" arrangement allows the grantor to revoke the trust at any time prior to death — and reclaim the assets. The Internal Revenue Service generally considers this type of arrangement to be a "grantor trust" and

treats the grantor as the owner of the trust property and income. The Internal Revenue Service will no doubt issue additional guidance over the coming months that will further clarify this issue under the new law.

9. Do I have to purchase a replacement residence in order to claim this new exclusion?

No. ***You are not required to purchase a replacement residence.*** Under old law, a seller could rollover gain from the sale of a principal residence without paying tax as long as a new residence was purchased within a specific period of time at a price equal to or greater than the sales price of the old residence. This rollover provision has been repealed except under certain interim rules for transactions which occurred on or before August 5, 1997. *(See Question #20, below.)*

10. Can I claim this exemption more often than every two years?

Maybe. Under very limited circumstances, you are entitled to a percentage of the exclusion even if (i) you have not owned your residence for two years, or (ii) it has been less than two years since you sold another principal residence. These special circumstances include a change in your place of employment or health. Also, the new law directs Treasury to issue regulations to provide the same treatment for sales made due to "unforeseen circumstances."

11. I've been in my home for 18 months, and have to sell it and move because I've been transferred to another state with my work. I will have a $30,000 gain. Can I exclude any of it?

Yes. If you sell before two years because of employment changes or because of ill health, you can exclude a fraction of the gain. The statute is somewhat misleading and could result in harsh consequences. The IRS will clarify the computation methods, because the Administration intended that taxpayers should benefit from, and not be harmed by, the new law. *(See Question #31, below.)*

12. Does the new law allow me to deduct a loss on the sale of my principal residence?

No. Losses on the sale of your principal residence remain nondeductible.

13. If my gain is less than $250,000 ($500,000 for married taxpayers), can I apply the unused portion to a future sale?

No. Any unused portion simply disappears. However, you will again be eligible for the entire exclusion 2 years after you sell your current residence.

14. How do the exclusion and the lowered capital gains tax rates relate to each other?

If you qualify for the exclusion, the first $250,000 ($500,000 for qualifying married taxpayers) of gain on the sale of your principal residence is not taxable;

any gain that exceeds this exclusion is subject to tax at capital gains rates in effect on the date of sale.

15. If my gain is taxable, what is the new tax rate?

Effective May 7, 1997, the new rules reduce the capital gains tax rate from 28% to 20% (10% for taxpayers in the 15% tax bracket).

16. I already used the one-time $125,000 exclusion for a residence I sold before May 7, 1997. Can I still claim this new exclusion?

Yes. Your eligibility for the new $500,000 exclusion is not affected by whether or not you claimed the old $125,000 exclusion.

17. My brother and I and one of his friends own a home together that we use as our principal residence. Each of us is single. How will the new exclusion affect us when we sell the residence?

Each of you will qualify for an exclusion up to $250,000. Thus, as much as $750,000 of gain on the sale could be excluded from tax. Since each of you files your tax return as a single person, each of you will qualify for your own exclusion on your portion of the gain.

18. Do I have to use this exclusion?

No. However, if you elect not to use the new exclusion, any gain would be taxable, because the old rollover option is repealed. *(See Question #9, above.)* However, if you purchased or sold between May 7, 1997, and August 5, 1997, you should *consult your tax advisor to see if limited rollover provisions apply to you.*

19. I sold my principal residence before May 7, 1997. Can I take advantage of this new exclusion?

No. Sales made before May 7, 1997, do not qualify. Instead, you are required to use the old "rollover" provisions. Under those rules you can defer the gain on the sale if you purchase a new principal residence within two years (before or after) the sale of your old residence. If you do not purchase a new residence within this time period, any gain will be subject to tax at capital gains rates in effect on the date of sale.

20. I sold my principal residence after May 6, 1997, and before August 5, 1997, but do not satisfy the two-year requirements of either the Ownership or Use Tests. Since I do not qualify for this new exclusion, how will this sale be taxed?

For sales made during this period, you can elect to use the old rollover provisions. If, however, you do not reinvest the proceeds into the purchase of a new principal residence within two years, your gain will be subject to tax at capital gains rates in effect on the date of sale.

21. I sold my principal residence on or after August 5, 1997, but I do not qualify for the new exclusion. How will this sale be taxed?

Generally, any gain will be treated as a capital gain.

22. My spouse died this year, and now I want to sell our principal residence. Can I claim the $500,000 exclusion?

Maybe, *but in order to qualify for the full $500,000 exclusion, you must sell your residence during the same tax year in which your spouse dies.* The reason for this is that you are allowed to claim the $500,000 exclusion only if you file a joint return, and after the death of your spouse, you are permitted to file a joint return only for the year of death. If you sell in a later year and file a single person return, you qualify only for a $250,000 exclusion. You should check with a tax advisor to see if the estate tax laws could favorably affect measurement of your gain.

23. I bought my house in 1990 and owned it on May 7, 1997. I plan to sell it soon. How do I determine my basis for measuring gain when I sell?

The starting point is your purchase price for the residence you bought in 1990. If you rolled over gain from the sale of a prior residence, you must subtract any gain that you realized and deferred from earlier transactions. If you did do a rollover, you should review the Form 2119, "Sale of Your Home", that you filed with your tax return for the year you sold your earlier residence. That form will show the adjusted basis of your current residence after rollover of the earlier gain.

Whether you start with the actual purchase price or an adjusted basis as determined in a prior rollover transaction, your basis is increased by adding the cost of major improvements or special tax assessments and subtracting any depreciation (e.g., which you might have taken as a prior home office deduction). The instructions for Form 2119 include a detailed worksheet to help you determine your correct basis.

24. I sold my house on September 1, 1997, and qualified for the $500,000 exclusion. On September 2, 1997, I bought a new house for $150,000. I plan to sell it as soon as I again qualify for the exclusion. How do I determine my basis for measuring gain when I sell?

Your basis will simply be the purchase price of the $150,000 home plus improvements. The fact that you claim the $500,000 exclusion does not affect the basis of any residence you later purchase.

25. What are the record keeping requirements?

For federal purposes (your state requirements may differ), you should maintain records showing the purchase price and any improvements to your residence for as long as you own the property, and then for three years after you file your return on which you report

the sale. For example, if you sell your residence in 1997, you will report this sale on the return you file on April 15, 1998; therefore, you should retain records until April 15, 2001, showing the original purchase price and any improvements.

26. My spouse and I purchased a residence over five years ago, lived in it for a while, then converted it to a rental property. If we sell this property today, we will have used it as our principal residence for fewer than two of the last five years. Can we still claim a portion of the exclusion?

Maybe. Although the law is clear that you do **not** qualify for any portion of the exclusion if you fail any of the tests, there are two exceptions to this rule. First, if you were forced to sell your residence under the special circumstances noted above (i.e., change in your place of employment or health — *See Question #10, above*), you may qualify for a partial exclusion of gain. Also, there is a ***special transitional rule*** that allows you to exclude a part of the gain — even though you do not satisfy the Ownership and Use Tests — *provided you owned the residence on August 5, 1997,* the date this new law was enacted. Individuals who owned property on August 5, 1997, and cannot satisfy the Ownership and Use Tests should check with a tax advisor to clarify the application of this special transitional rule.

27. My spouse and I purchased a residence over five years ago and lived in it until a little over two years ago. Can we claim this new exclusion even though we do not now use this property as our principal residence?

Yes. The property does not have to be your principal residence on the date of sale. In fact, even if your former principal residence is used as rental property on the date of sale, you could still qualify for the exclusion provided you satisfy the Ownership, Use and Waiting Period Tests, as discussed above.

28. My husband and I have owned residential rental property since 1985, during which time we have claimed depreciation deductions. We plan to move into the property in 1999 and live there for at least two years so that we can satisfy all the ownership and use tests so that it will become our principal residence. Assuming that there are no changes to the law, what will be tax consequences when we sell it?

The first thing you will need to do is begin your tax planning today. Once you have satisfied the Ownership, Use and Waiting Period Tests, you should be able to claim the exclusion on this property. The tricky issue here involves the depreciation you claimed on this residence while it was being used as a rental property. To determine the tax treatment of this transaction you must know both the (i) total depreciation claimed, and (ii) the amount of depreciation claimed ***after May 6, 1997.***

Your tax basis will be determined by reducing your original purchase price by the total depreciation claimed on this property and adding the costs of any capital improvements you might have made. Next, you determine your total gain by subtracting your tax basis from the sales price. The total gain would then be reduced by the amount of depreciation claimed *after May 6, 1997*. This portion of the depreciation will be taxed under the new depreciation recapture rules (which provide for a maximum rate of 25%), while the remaining gain, if any, will qualify for the exclusion. ***Note that the depreciation you claimed on your principal residence before May 7, 1997, is NOT subject to the depreciation recapture tax. However, that depreciation — along with the portion of depreciation subject to the recapture tax — does reduce your tax basis.***

Example 1: The cost of the property was $200,000. You have claimed depreciation of $50,000 ($1,000 of which was taken after May 7, 1997), so your basis is $150,000 ($200,000 minus $50,000). If you sell this property for $500,000, you will have a $350,000 gain ($500,000 less your basis of $150,000). Of this gain, the depreciation of $1,000 taken after May 6, 1997, will be subject to depreciation recapture tax. However, assuming you and your spouse qualify for the $500,000 exclusion, all of the remaining gain of $349,000 is excluded from capital gains tax.

Example 2: The cost of the property was $200,000. You have claimed depreciation of $50,000 ($1,000 of which was taken after May 7, 1997), so your basis is $150,000 ($200,000 minus $50,000). If you sell this property for $700,000, you will have a $550,000 gain ($700,000 less your basis of $150,000). Of this gain, the depreciation of $1,000 taken after May 6, 1997, will be subject to depreciation recapture tax. However, assuming you and your spouse qualify for the exclusion, $500,000 of the remaining gain of $549,000 is excluded from capital gains tax, and you would be subject to capital gains tax on only $49,000 of the total gain.

29. I have taken a home office deduction on my tax return for a number of years. Will this affect whether or not I qualify for the new exclusion?

Maybe. If you maintain an office in your home during the year of sale, the portion of the gain attributable to your home office will not qualify for the exclusion. Instead that portion will be taxed as a capital gain and any depreciation will be subject to recapture tax. If, however, you converted your home office back to your principal residence for the year of sale, all of the gain would qualify for the exclusion, except for gain attributable to depreciation claimed after May 7, 1997, which will be subject to depreciation recapture tax at the maximum rate of 25%.

30. What is the tax rate for depreciation recapture?

For depreciation recapture you are taxed at your normal tax bracket rate, but only to a maximum of 25%. Therefore, some taxpayers will be taxed on depreciation recapture at their regular tax rate of 15%, while others not in the 15% tax bracket will be taxed at the maximum rate of 25%.

31. Where can I learn more about these rules?

The IRS Publication 523, *Selling Your Home (For Use in Preparing 1997 Returns)*, will reflect all these new rules. That publication is updated annually, and the 1997 version that describes these changes and other important considerations for selling your home or buying a new one should be available by the end of 1997.

For further information, contact NAR's Government Affairs Customer Service Representative at 202-383-1194.