Federal Tax / Capital Gains Exclusion on Sale of Principal Residence

NAR Committee:

Federal Taxation Committee

What is the fundamental issue?

In 1997, Congress enacted an exclusion for the gains on the sale of a principal residence. Taxpayers who file a joint return can exclude up to $500,000 of gain from taxation. All others may exclude $250,000. The 1997 provision was not indexed for inflation. In 2007, Congress enacted a modest limitation on the value of the exclusion when an individual sells a home that once was used as a second home or rental property and then later converted to a principal residence.

In some areas of the nation that have experienced high amounts of residential real estate price appreciation, the $250,000/$500,000 maximum exclusion amounts sometimes prove too small to entice some homeowners with very large unrealized gains to want to sell their homes, even when they wish to do so because of the need to downsize or for other reasons. This has a tendency to freeze the real estate market in certain areas, resulting in fewer transactions.

I am a real estate professional. What does this mean for my business?

The exclusion is the most taxpayer-friendly provision enacted in many years. It offers an excellent retirement planning foundation. The 1997 legislation eliminated the requirement that proceeds from the sale of a principal residence be reinvested in another property of the same or greater value. This change facilitated mobility from high cost to lower cost areas, and also greatly simplified the tax compliance burden for homeowners. Moreover, it allows the homeowner the greatest freedom in the use of his/her capital. Proceeds from the sale of a principal residence may be used to purchase another principal residence, a second home, investment property or in any other manner the owner chooses.

The lack of an indexing feature for the maximum exclusions means that every year the exclusion becomes less valuable as home sales prices reach and exceed the $250,000 and $500,000 amounts. Thus, the benefits of the 1997 change erode as prices climb due to inflation, but the thresholds do not.

NAR Policy:

The $250,000/$500,000 exclusion amount should be indexed for inflation.

Opposition Arguments:

Opponents may say that this is just another tax benefit that mostly benefits higher-income taxpayers.

Legislative/Regulatory Status/Outlook

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No proposals have been introduced that would modify present law as it applies to the exclusion. However, NAR believes that a good tax reform plan should correct problems such as the lack of the exclusion being indexed for inflation. An early version of the Tax Cuts and Jobs Act of 2017 would have made the exclusion less useful than current law and did not index the thresholds for inflation. NAR was able to defeat this harmful change, which was a victory. However, the thresholds are still unindexed, and NAR is still working with Members of Congress to urge them to sponsor legislation to increase and/or index the thresholds.

Current Legislation/Regulation (bill number or regulation)

None at this time.

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