Capital Gains Tax on Real Estate Sales

I. Taxation on Sale of Principal Residence

Q 1. ***What happens if I sell my principal residence?***

A Individuals are generally permitted to exclude from income up to $250,000 ($500,000, in general, for married couples filing a joint return) realized on the sale or exchange of their principal residence (26 U.S.C. § 121 also cited as IRC § 121).

Q 2. ***May I use this exclusion more than once?***

A Yes, but generally not more than once every two years. In order to qualify, you must have owned and used the property as your principal residence for at least two years during the five-year period ending on the date of the sale or exchange. In addition, the two-year periods do not have to be continuous. (IRC § 121.)

Q 3. ***May I use this exclusion in connection with Internal Revenue Code ("IRC") section 1034 "rollover" of gain on the sale of my principal residence if I purchase a home of equal or greater value?***

A No. The IRC § 1034 provision allowing a delay in the recognition of gain when purchasing a replacement residence of equal or greater value was repealed by the 1997 Act (IRC § 121).

Q 4. ***May I still take a one-time exclusion of $125,000 of gain from the sale of my principal residence if I am age 55 years or older?***

A No. This exclusion was also repealed by the 1997 Act.

Q 5. ***If I have previously used the $125,000 exclusion of gain, am I prohibited from using the new $250,000 ($500,000 for married couples filing jointly) exclusion of gain?***

A Generally no. Even if you have previously taken the one-time $125,000 exclusion, if you are otherwise eligible for the exclusion you can take advantage of the $250,000 exclusion ($500,000 for married couples filing jointly) as often as you meet the requirements. (IRC § 121.)

Q 6. ***How does the exclusion apply to married couples?***

A The $500,000 exclusion applies to married couples filing jointly when all of the following conditions are met:

· Either spouse meets the ownership requirement;

· Both spouses meet the use requirement; and

· Neither spouse has had a sale of their principal residence in the preceding two years subject to the exclusion.

(IRC § 121.)

Q 7. ***What if I marry someone who has used the exclusion within two years prior to our marriage?***

A Even though your spouse has used the exclusion within two years prior to your marriage, you would still be allowed a $250,000 exclusion. Once both spouses satisfy the eligibility requirements and two years have passed since the last exclusion was allowed to either spouse, a full $500,000 exclusion would be allowed for the next sale or exchange of a principal residence. (IRC § 121.)

Q 8. ***If my spouse dies, must I sell our principal residence within the year of my spouse's death in order to take advantage of the $500,000 exclusion from gain?***

A No. The 2007 Act amends IRC § 121(b) to allow the exclusion of $500,000 in capital gains tax if the principal residence is sold within two years of the spouse's death (but this applies only for sales after December 31, 2007).

Q 9. ***What if I move before I have occupied my residence for two years or before two years have elapsed since the last time I sold or exchanged my principal residence?***

A If you fail to meet either two-year requirement, you will still be entitled to a pro-rata amount of the exclusion as long as the failure to meet the requirement is because the sale or exchange is by reason of a change in place of employment, health or other unforeseen circumstances.

The 1998 Act provides that this ratio is that portion of the $250,000/$500,000 exclusion equal to the fraction of the two years that the ownership and use requirement is met. Therefore, an unmarried taxpayer who owns and uses a principle residence for one year and then sells because of a job transfer may exclude up to $125,000 of gain (one-half of the regular $250,000 exclusion).

Example: Ms. Seller purchased and occupied her principal residence in 1998. One year later, she is transferred by her employer to another city and sells her

house for a $100,000 gain. Because she occupied her residence for one-half of the required two years, Ms. Seller is entitled to exclude up to one-half of the $250,000 otherwise allowed, thereby covering her entire $100,000 gain. This is a change from the IRS?s previous position allowing her to exclude only one-half of her gain, or $50,000.

Q *10. Are there clarifications to the permissible reasons for sale or exchange allowing a pro-rata exclusion?*

A Yes. Treasury regulations provide clarifications and safe harbors for the exemptions from the two-year period. Treasury Regulation 1.121-3(b) provides that a sale or exchange is by reason of a change in employment, health, or unforeseen circumstances only if the *primary reason* for the sale or exchange is a change in place of employment, health or unforeseen circumstances. The regulation provides the following guidelines and safe harbors:

Place of Employment

Generally, a sale or exchange is deemed to be a change in employment if the primary reason for the sale or exchange is a change in the location of a qualified individual's place of employment. (See Question 11 for a definition of *qualified individual*.)

The regulation provides a distance safe harbor if (i) the change of employment occurs during the period of the taxpayer's ownership and use of the property as the taxpayer's principal residence, and (ii) the individual's new place of employment is at least 50 miles further from the residence sold or exchanged than was the former place of employment, or, if there was no former place of employment, the distance between the individual?s new place of employment and the residence sold or exchanged is a least 50 miles.

For purposes of the regulation, employment includes starting a job with a new employer, continuing employment with the same employer, and starting or continuing self-employment.

Health

A sale or exchange is by reason of health if the primary reason for the sale or exchange is to obtain, provide, or facilitate the diagnosis, cure, mitigation, or treatment of disease, illness, or injury of a *qualified individual*, or to obtain or provide medical or personal care for a qualified individual suffering from a disease, illness or injury. A sale or exchange that is merely beneficial to the general health or well-being of the individual is not a sale or exchange by reason of health.

The regulations provide a safe harbor if a physician recommends a change of residence for reasons of health. (See Question 11 for a definition of *qualified individual*.)

Unforeseen Circumstances

A sale or exchange is by reason of unforeseen circumstances if the primary reason for the sale or exchange is the occurrence of an event that the taxpayer does not anticipate before purchasing and occupying the residence.

The regulations provide a safe harbor for any of the following events occurring during the taxpayer's ownership and use of the residence as the taxpayer's principal residence:

1. The involuntary conversion of the residence;

2. Natural or man-made disasters or acts of war or terrorism resulting in a casualty to the residence;

3. In the case of a *qualified individual*:

a. Death;

b. The cessation of employment as a result of which the individual is eligible for unemployment compensation;

c. A change in employment or self-employment that results in the taxpayer?s inability to pay housing costs and reasonable basic living expenses for the taxpayer's household (including amounts for food, clothing, medical expenses, taxes, transportation, court-ordered payments, and expenses reasonably necessary to the production or income, but not for the maintenance of an affluent or luxurious standard of living);

d. Divorce or legal separation under a decree of divorce or separate maintenance;

e. Multiple births resulting from the same pregnancy; or

4. An event determined by the Commissioner to be an unforeseen circumstance to the extent provided in published guidance of general applicability or in a ruling directed to a specific taxpayer.

(See Question 11 for a definition of *qualified individual*.)

(26 C.F.R. § 1.121-3.)

Q 11. ***Who is a "qualified individual" as used in Question 10?***

A *Qualified individual* is defined in the regulations as the taxpayer, the taxpayer's spouse, a co-owner of the residence, or a person whose principal place of abode is in the same household as the taxpayer. For purposes of the pro-rata exclusion of gain for a sale or exchange due to health only, a qualified individual also includes (i) an individual with a relationship described as a dependent in IRC § 152(a)(1) through (8), without regard to whether they are actually a dependent, or (ii) a descendent of the taxpayer's grandparent. (26 C.F.R. § 1.121-3(f).)

Q 12. ***What if I do not qualify for a safe harbor?***

A The regulations provide the following factors, which may be relevant in determining the taxpayer's primary reason for the sale or exchange:

1. The sale or exchange and the circumstances giving rise to the sale or exchange are proximate in time;

2. The suitability of the property as the taxpayer's principal residence materially changes;

3. The taxpayer's financial ability to maintain the property materially changes;

4. The taxpayer uses the property as the taxpayer's residence during the taxpayer's ownership of the property;

5. The circumstances giving rise to the sale or exchange are not reasonably foreseeable when the taxpayer begins using the property as the taxpayer's principal residence; and

6. The circumstances giving rise to the sale or exchange occur during the period of the taxpayer's ownership and use of the property as the taxpayer's principal residence.

(26 C.F.R. § 1.121-3(b).)

Q 13. ***May I deduct a loss on the sale of my principal residence?***

A No. Although there were discussions about allowing homeowners to deduct losses on the sale of their principal residence, this provision did not become law.

Q 14. ***If I have gains from the sale of my principal residence above the $250,000/$500,000 exclusion limits, what tax rate will I pay?***

A Depending on the length of time you owned your principal residence, your gain may be taxed at the more favorable capital gain rates discussed below. See Section II, below.

Q 15. ***Are there more special rules?***

A Yes, including, among others, the following:

· A taxpayer can elect not to have the exclusion apply to any sale or exchange.

· Certain periods an individual resides in a nursing home on account of physical or mental incapacity are included as part of the two-year use requirement if certain other rules apply.

· An individual whose spouse is deceased on the date of the sale of the property can include the period the deceased spouse owned and used the property before death.

· An individual is treated as using the property as his or her principal residence during any period of ownership while the individual's spouse or former spouse is granted use of the property under a divorce or separation instrument.

Q 16. ***What happens if I transfer my principal residence into a revocable living trust?***

A IRC § 676 provides that a grantor (the person who creates and funds the trust) is treated as the owner of the property when the grantor retains the power to revoke the trust and revest title in him or herself. The 2003 Act does not change this provision. This means that the $250,000 exclusion ($500,000 if married filing jointly) applies to a sale or exchange by a revocable living trust so long as the grantor of the trust and owner of the property before it was conveyed to the trust are the same person and that person, either as owner or grantor, has owned and used the property as his or her principal residence for two of the previous five years. In other words, because the grantor is still treated as the owner of the property, the transfer into the trust is not a taxable event.

Q 17. ***May I utilize an IRC 1031 ("like kind" tax-deferred exchange) in connection with an owner-occupied residence?***

A No. However, individuals sometimes exchange one rental property for another planning to move into the acquired property and, after living in it for two years, sell it and take advantage of the capital gains exclusion. This sometimes occurred as soon as three or four years after the acquisition. As of October 22, 2004, this was no longer possible. Pursuant to the American Jobs Creation Act of 2004, a property acquired in a 1031 exchange and later converted to a principal residence must by owned for five years from the date of the exchange before the

owner can claim the capital gains exclusion. Therefore, in order to take advantage of a 1031 exchange and the capital gains exclusion, the owner must both have used the acquired property as a principal residence for two years and owned it for five years.

Q 18. ***Is the exclusion treated differently for the sale of a principal residence that was used as a second home or as income property during the ownership period?***

A Yes. For any periods of ownership occurring on or after January 1, 2009, under the Housing and Economic Recovery Act of 2008 (H.R. 3221), the exclusion from capital gains recognition will be reduced by the amount of time the property was not used as a principal residence ("non qualified use"). The gain from the sale will be allocated between periods when the property was used as a principal residence ("qualified use") and periods of non-qualified use. The math is as follows: The gain is multiplied by a fraction where the top number (the numerator) is the period that the property was used as a principal residence (qualified use) and the lower number (the denominator) is the total period of ownership.

Gain **x** (Time of qualified use/Total time owned) **=** exclusion from capital gains (capped at $250,000 and $500,000).

Example: A married couple filing jointly purchased a vacation property on January 2, 2009 which they sell on January 2, 2017 for a gain of $600,000. During the last two years of ownership they occupied the property as their principal residence. They would multiply $600,000 gain by 2 years of qualified use divided by 8 total years of ownership (or $600,000 x ¼ = $150,000). They could exclude $150,000 from capital gains (which is less than the $500,000 cap for joint filers) and the balance of the $600,000 gain, $450,000 would be taxed as capital gains.

Q 19. ***Are there exemptions from the non qualified use rules?***

A Yes. There are three exemptions from the non qualified use rules:

1) Any portion of the 5-year ownership and use requirement occurring after the last date the property was used as a primary residence of the taxpayer or the taxpayer's spouse.

Some examples may help.

Example One:

In January 2009, married taxpayers filing a joint return buy a house and use it as their principal residence for the first two years. They then convert the residence to a rental for the next three years, after which they sell the residence and realize gain of $600,000. None of the three years of otherwise non qualified use after the initial use as a principal residence would be used to reduce the capital gains exclusion. They would be entitled to the full $500,000 exclusion and would owe capital gains on $100,000.

The formula would be the $600,000 gain times the five years of qualified use (the initial two-year qualifying use period plus the balance of the five-year qualifying ownership period following the two-year qualifying use period) over the five year total ownership period.

$600,000 **x** 5/5 **=** $600,000 qualifying gain (capped at $500,000 for joint filers).

Example Two:

The same couple buys a house in January 2009 and rents it out for the first three years. They then convert it to their principal residence for the next two years. Following this they once again rent the residence out, this time for three years, after which they sell the residence for $600,000 gain. They owned the property for a total of eight years. They have three years of non qualified use and five years of qualified use (the two-year qualifying use period plus the balance of the five-year qualifying ownership following the two-year qualifying use period).

The formula would be $600,000 gain times five years of qualified use over eight total years of ownership.

$600,000 **x** 5/8 **=** $375,000 excluded from capital gains and capital gains tax would be owed on $225,000.

Example Three:

The same couple buys a house in January 2009 and rents it out for six years. They then occupy it as their principal residence for two years and sell it for $600,000 gain. Since none of the five-year qualifying ownership period occurs after the two-year qualifying use period only the last two years of occupancy count as qualified use.

The formula would be $600,000 times 2 years of qualified use over 8 total years of ownership.

$600,000 **x** 2/8 [or 1/4] **=** $240,000 excluded from gain and capital gains tax would be owed on $360,000.

The other two exemptions from the non-qualified use rules are:

2) Any period (not to exceed an aggregate period of 10 years) during which the taxpayer or taxpayer's spouse is serving on extended official duty as a member of the Foreign Service or the uniformed services of the United States, and

3) Any other period of temporary absence (not to exceed an aggregate of two years) due to change of employment, health conditions, or other such unforeseen circumstances.

For more examples of calculating capital gains exclusions visit N.A.R.'s website at http://www.realtor.org/gapublic.nsf/pages/hr_3221_key_provisions.

II. Capital Gains Tax

Q 20. ***What are the basic capital gains tax rates?***

A The 2003 Act reduced the maximum rate on the net capital gains rate of an individual (net long-term capital gains less net short-term capital losses) from 20 percent to 15 percent. Net capital gains previously taxed at 10 percent were reduced to 5 percent.

Q 21. ***Has the holding period for long-term capital gains changed?***

A In order to qualify for long-term capital gains treatment, property must be held for more than 12 months.

Q 22. ***Are there further capital gains tax rate reductions?***

A In 2008, the capital gains tax rate for gains taxed in the lowest tax bracket (5 percent) will be reduced to zero.

Q 23. ***When did the reductions in capital gains take effect?***

A The 2003 Act took effect May 6, 2003 and applies to taxable years ending on or after May 6, 2003.

Q 24. ***Do these capital gains rates expire?***

A Unless the U.S. Congress extends them, under Section 102 of the 2007 Act the capital gains rate reductions will sunset December 31, 2010, at which time the rates will revert to 20 percent and 10 percent.

Q 25. ***Are there any changes to depreciation recapture rules?***

A No. Generally, when selling investment real property, a tax is imposed on all amounts previously taken as depreciation. Under prior law, these amounts were taxed as ordinary income and not capital gains.

The 1997 Act provides for a 25 percent maximum tax rate on any gain attributable to depreciation already claimed on the property in the case of real property for which the maximum tax rate is reduced to 15 and 5 percent. Although there was an effort to reduce the recapture rate, no reduction materialized.

Example:
Ms. Seller purchases a triplex for $200,000 after January 1, 2001, and takes depreciation deductions of $50,000 over the six years she owns it. She sells the duplex for $300,000. Her basis in this property is reduced to $150,000 because of her deductions for depreciation, and she would have a $150,000 gain.

Under the 2003 Act, she would be taxed at a 15 percent (or 5 percent) rate on the $100,000 portion of gain over her original $200,000 basis and at a 25 percent rate on the $50,000 portion of gain attributable to her depreciation deduction.

Q 26. ***Can you provide a summary of the capital gains tax rates?***

A Yes. Sales of assets held more than 12 months and sold on or after May 6, 2003 qualify for the 15 percent capital gains rate (5 percent for lowest income taxpayers and zero percent beginning in 2008). The capital gains rate reverts to 20 and 10 percent for assets held for more than 12 months and sold after December 31, 2010.

Q 27. ***Can I still take advantage of an IRC 1031 ("like kind" tax-deferred) exchange?***

A Yes. The tax-free exchange of "like-kind" property used in a trade or business is not affected by the 1997, 1998, 2003 or 2007 Acts.