

## **Locking Down the Home Sale Tax Exclusion**

Even with real estate prices depressed in many parts of the country, long-time homeowners might be liable for tax on a sizeable gain when they finally sell the family abode. Fortunately, a special tax law provision may enable taxpayers to reduce or completely avoid the capital gains tax. This provision includes both a “use” and “ownership” test.

Background: By making a tax return election, a taxpayer can exclude from taxable income up to \$250,000 of gain—or \$500,000 for joint filers—from the sale of a home. To qualify for this tax exclusion, the home must have been owned and used by the taxpayer as a principal residence for at least two of the five years prior to the sale.

This home sale exclusion generally does not apply, however, if the taxpayer sold another qualified principal residence within the last two years. Theoretically, someone could qualify for the home sale exclusion every two years.

Keeping those basic rules in mind, here are some of the key points about the home sale exclusion:

- \*The home must be used as a principal residence for any two of the last five years. The years do not have to be consecutive. Furthermore, a taxpayer can meet the use and ownership requirements in different tax years.
- \*Joint filers can claim the maximum exclusion if (1) either spouse meets the two-year ownership test, (2) each spouse meets the two-year use test and (3) neither spouse has elected the exclusion within the last two years. This is particularly important for taxpayers who have recently divorced or remarried.
- \*In order to meet the use requirement, the taxpayer must physically occupy the home, but short absences are allowed. Conversely, a longer absence, such as a one-year sabbatical by a college professor, does not count as time that the home is being used as the principal residence.
- \*If someone owns two homes and lives in both places during the year, the home where that person stays for most of the year is generally treated as the principal residence. For instance, if a taxpayer spends seven months at a winter home and five months at a summer home, the winter home is considered to be the principal residence.

\*To the extent that the home has been used for business or rental use—including using a portion of the residence as a home office—the taxpayer must recapture allowable depreciation deductions attributable to the period after May 6, 1997. Any unrecaptured income is taxed at the 25% rate, as opposed to the current maximum 15% capital gains rate.

Finally, a partial exclusion may be available due to a change in employment, a health reason or other unforeseen circumstances from an event that could not have reasonably been anticipated.

Reminder: This is just a general overview of the key rules. It is recommended that homeowners obtain professional assistance concerning the tax ramifications of a sale.