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Sale of Principal Residence: Tax Considerations

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Introduction

You should be aware of the federal income tax issues that may arise upon the sale of your principal residence. In particular, you should understand how to calculate capital gain (or loss), and know when capital gain can be excluded from taxation. You should also know which items you can deduct on your tax return for the year of sale, and how closing costs are treated. Additionally, if you rent a portion of your principal residence to tenants or use part of your residence for business purposes, special tax rules may apply.

> **Tip:** This discussion applies to the sale of your principal residence only. For the tax treatment of the sale of your second home or vacation home, see Special Considerations for Second/Vacation homes.

What is a principal residence?

Although you might own several homes, you can have only one principal residence. The home in which you spend most of your time during the year will ordinarily be considered your principal residence. However, the IRS has listed other factors that are relevant in determining your principal residence. These factors include (but are not limited to) the following:

- The address listed on your income tax returns, driver's license, and automobile and voter registrations
- Your place of employment
- Your mailing address for bills and correspondence
- The location of your family members
- The place you maintain your bank accounts
- The location of your memberships (e.g., places of worship, clubs, etc.)

> **Tip:** For purposes of qualifying for the capital gain exclusion, you must have an ownership interest in the residence (i.e., legal title), rather than simply a right to occupy (as a tenant would have). Single family homes can qualify as principal residences, along with condominiums, co-ops, mobile homes, houseboats, and trailers (assuming they have living accommodations that include a sleeping space, toilet, and cooking facilities).

An investment in a retirement community will not qualify as your principal residence unless you receive equity in the property.

How do you calculate capital gain or loss when you sell your principal residence?

In general

The sale of your home will ordinarily result in either a capital gain or a capital loss. Gain (or loss) on the sale of your principal residence is the selling price (less expenses of the sale) minus your adjusted basis in the residence. If the sales price of your residence exceeds your adjusted basis in the home, you'll realize a capital gain. If the sales price of your principal residence is less than your adjusted basis in the residence, you'll realize a capital loss. You generally can't claim such a loss as a deduction on your federal income tax return.

> **Tip:** If you pay a broker's commission for selling your home, your sales price is reduced by the amount you paid to the broker.

Adjusted basis

In general, the adjusted basis of a personal residence is the cost of the property (i.e., what you paid for the property when you first purchased it), plus amounts paid for capital improvements, less any depreciation and casualty losses claimed for tax purposes.

> **Tip:** Improvements add value to the home, prolong its life, or adapt it to a new use. Regular repairs and maintenance are not considered improvements and are not included in the tax basis of the home.

> **Tip:** Depreciation deductions would apply only if you had used your home for business purposes.

If you are selling your home and you pay some or all of the buyer's points at closing, your adjusted basis is not affected. Rather, for tax purposes, you must reduce the sales price of the home by the amount of seller-paid points. For more information about adjusted basis, see IRS Publication 523, Selling Your Home.

Under what conditions may you exclude gain from the sale of your principal residence?

Full exclusion

If you sell your principal residence at a gain, you may be able to exclude from taxation all or part of the capital gain. If you meet the requirements, you can exclude up to $250,000 (up to $500,000 for married couples filing jointly) of the capital gain, regardless of your age.

You can generally exclude the gain only if you owned and used the home as your principal residence for at least two out of the five years preceding the sale (the two years do not have to be consecutive). An individual, or either spouse in a married couple, can generally use this exclusion only once every two years.

Special rules may apply in the following cases:

- If you sell property within five years of acquiring the property through a like-kind exchange
- If you sell vacant land adjacent to your principal residence
- If your principal residence is owned by a trust
- If your principal residence contained a home office or was otherwise used partially for business purposes
- If you rented part of your principal residence to tenants, or used it as a vacation or second home (i.e., "nonqualifying use" under the Housing and Economic Recovery Act of 2008)
- If you owned your principal residence jointly with an unmarried taxpayer
- If you are a member of the uniformed services or foreign services personnel on qualified official extended duty

For more information about these special cases, see IRS Publication 523, Selling Your Home.

> **Tip:** Previously, a surviving spouse was entitled to the $500,000 exclusion only if he or she filed a joint return with the deceased spouse's estate, which can only occur for the tax year in which the deceased spouse dies. The Mortgage Forgiveness Debt Relief Act of 2007 extended the period of time in which the surviving spouse has to take the $500,000 home sale exclusion. For sales on or after January 1, 2008, the sale of a jointly-owned and occupied residence is entitled to the $500,000 exclusion provided the sale occurs no later than two years after the date of the deceased spouse's death.

Partial exclusion

A partial exemption may be available even if you fail to meet the two-out-of-five-years test or the one-sale-in-two-years test. You may claim a partial homesale exclusion if the primary reason for selling your house is a change in place of employment, for health reasons, or for certain other unforeseen circumstances (e.g., your home was sold because you were directly affected by the September 11, 2001, terrorist attacks). Generally, you must establish by the facts and circumstances of your situation that your home sale was for one of these reasons.

The IRS has issued temporary regulations that clarify the meaning of the above conditions (change in place of employment, health reasons, and unforeseen circumstances). In addition, various "safe harbors" exist that will automatically establish that a sale is for one of these reasons.

> **Tip:** If the capital gain from the sale of your home is entirely excluded from federal income taxation, you don't have to report the sale transaction on your income tax return. However, if part or all of your capital gain is taxable, you must report the transaction on Schedule D of your federal income tax return.

What can you deduct on your federal income tax return for the year you sell your principal residence?

In general

If you did not rent your principal home to others (or if you rented it for fewer than 15 days during the year), you can deduct the following home-related expenses on your income tax return:

- Property taxes
- Qualified interest on loans secured by the residence
- Certain casualty losses
- Qualified mortgage insurance premiums

> **Tip:** If you rent your principal home for fewer than 15 days a year, any rental income you receive is not considered taxable income.

Deducting property taxes

If you itemize your deductions on Schedule A of your federal income tax return, you may be able to deduct the property taxes you paid during the year for your principal home. A home seller is responsible for real estate taxes up to the date of sale. At the closing, you and the buyer divide the real estate taxes. You pay taxes up to (but not including) the date of closing. If you've already paid a tax bill for a period extending beyond the closing date, the buyer will reimburse you at the closing for that extra portion.

> **Tip:** For tax years 2008 and 2009 only, homeowners could claim an additional standard deduction for property tax if the taxpayer did not itemize. The additional amount that could be claimed was the lower of: (1) the amount of real estate property taxes paid during the year to state and local governments; or (2) $500 ($1,000 if married filing jointly).

Deducting mortgage interest

You may be able to deduct qualified interest you paid on a mortgage to buy, build, or improve your home, provided that the loan is secured by your home. You may also be able to deduct the interest you paid on a home equity loan. For more information about deducting mortgage interest, see Income Tax Considerations for Homeowners.

Deducting casualty losses

If you use your home only for personal (nonbusiness) purposes, you can't deduct your homeowners insurance premiums on your federal income tax return. However, if you suffer an insurance-related loss for which you are not fully compensated, you may be able to claim a casualty loss deduction on your income tax return.

Deducting qualified mortgage insurance premiums

For 2007 through 2011 only, premiums paid or accrued for qualified mortgage insurance is treated as deductible mortgage interest. Qualified mortgage insurance means mortgage insurance provided by the VA, FHA, and Rural Housing Authority as well as private mortgage insurance (PMI). The amount of the deduction is phased out if your AGI exceeds $100,000 ($50,000 if married filing separately). This provision does not apply with respect to any mortgage contract issued before January 1, 2007 or after December 31, 2011.

If you rented part of your home to others, or used part for business purposes

Special deduction and income-reporting rules apply if your principal residence was a multifamily home, a portion of which you rented to tenants for more than 15 days per year. In such a case, all rental income is reportable on your tax return. For purposes of deducting expenses, you must treat your principal residence as if it were two properties: one for personal use and one for rental use.

You deduct interest, taxes, and casualty losses attributable to the personal use portion on Schedule A of your return. You deduct from rental income the rental portion of interest and taxes, along with any expenses solely attributable to the rental activity. Depreciation is based on the rental portion of basis only. Losses from rental activity are deductible to the extent allowed by passive loss limitations. (Losses are not allowed on the personal-use portion.) For information about passive activities, see Converting a Residence to Rental Property.

Special deduction rules also apply if you used a room within your principal residence as a home office. In such a case, you may be able to deduct some of your housing expenses (including part of your homeowners insurance premiums) on your federal income tax return.

How do you treat the capital gain from the sale of mixed-use property (i.e., a principal residence used partly for business, investment, or rental purposes)

In general

In the past, the IRS took the position that if a principal residence was used partially for residential purposes and partially for business purposes (mixed-use property), any capital gain on the sale of the house would have to be prorated; that is, only the part of the gain allocable to the residential portion was eligible for exclusion.

Recently-issued final regulations, however, have adopted a more liberal position. All of the gain from the home sale (except for gain resulting from certain depreciation deductions) is eligible for the capital gain exclusion so long as both the residential and non-residential portions of the property are within the same dwelling unit (e.g., one room in the home is used as a home office). However, gain is allocated if the business portion of the home is separate from the dwelling unit (e.g., an office in a converted detached garage).

> **Example(s):** Assume a self-employed accountant bought a home and, five years later, sells the home at a $20,000 gain. Although the house was always used as his principal residence, the accountant used one room within the house as his business office. Over the years, the accountant claimed $2,000 of depreciation deductions for his office. Under the final regulations, $18,000 of the capital gain will be tax-free. Only the $2,000 of the gain equal to the depreciation deductions will be taxable. The taxable amount will be considered unrecaptured Section 1250 gain, which is taxed at a rate of 25 percent.
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> **Example(s):** If the accountant's office had been located in a converted detached garage on his property, he would have to treat the sale as two separate transactions and pay tax on the gain allocable to the converted garage.
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> **Caution:** If you have a home office or otherwise use part of your principal residence for business,

investment, or rental purposes, the capital gain on the sale of your home will not qualify for this exclusion to the extent of any depreciation deductions attributable to periods after May 6, 1997.

Multi-family homes

Be careful if you rent part of your principal residence to tenants. If you converted part of your residence into an apartment, or if you sell a multi-family house, you may not be able to exclude the gain from the rental portion of your house.

Example(s): Suppose you buy a three-story townhouse and convert the basement level (which has a separate entrance) into a separate apartment by installing a kitchen and bathroom there. You also remove access from the interior stairway that leads from the basement to the upper floors. After the conversion, you use the first and second floors of the townhouse as your principal residence and rent the basement level to tenants for four years. During that period, you claim depreciation deductions of $2,000. You sell the entire property, realizing a gain of $18,000.

Example(s): Because the basement apartment was considered a separate dwelling unit, you must allocate the capital gain between the portion of the property that you used as your principal residence and the portion of the property that you rented. You may exclude from taxation only the non-rental portion. Assuming that the gain allocable to the rental portion of the property came to $6,000, you'd recognize the $6,000 as income ($2,000 of which is gain from depreciation deductions and $4,000 of which is adjusted net capital gain).

Caution: Capital gain realized on the sale of pure investment properties and residences other than your principal residence (for example, vacation homes) cannot be excluded from taxation under the homesale exclusion rules.

Treatment of capital loss

If you sell your house at a loss, no loss is allowed on the personal use portion of your mixed-use residence. However, loss allocable to the business use portion may be deductible. Consult a tax professional.

For information about temporary rentals, see Temporary Rental of Principal Residence. See also Sale of a Principal Residence Converted to Rental Property: Tax Considerations.

How are closing costs treated when you sell your principal residence?

Generally, you can't deduct settlement costs on your income tax return when you sell your home. Often, however, if you pay certain settlement costs, such as a broker's commission, points owed by the buyer, transfer taxes, and other costs owed by the buyer, you can reduce the amount realized (sales price). This can be advantageous, because it will decrease your capital gain.

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