

Tax Implications Relating To The Sale Of A Principal Residence A Brief Overview

**Prepared By: James Michael Kemp
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I. SALE OF PRINCIPAL RESIDENCE

A. INTRODUCTION

The Taxpayer Relief Act of 1997 ("TRA 1997") was enacted to provide a more generous tax deduction, or more properly termed, avoidance, for individuals who sell a primary residence. Formerly, the rules were codified in IRC sec. 1034 and the former IRS sec. 121. However, the Taxpayer Relief Act of 1997 became applicable to all post May 6, 1997 home sales. In this Act, a seller of any age who has owned and used the home as a principal residence for periods aggregating at least two of the five years before the sale can exclude from income up to \$250,000 of gain, and \$500,000 for joint filers meeting certain conditions.

Of course the term gain refers to the appreciation that has accumulated during the course of ownership, if any. The rationale behind this law has always been to shield homeowners from inflationary, illusory gains when the majority of homeowners simply "trade-up" to a larger property. Due to the relatively high threshold, the current law serves to free all but a small percentage of taxpayers from the burden of retaining tax related records for determining the tax consequences for the sale of their principal residences.

Although the rules sound very straightforward, there are a few things to remember. It is prudent to consult a tax professional before deciding to include or exclude information relating to the sale of a principal residence on a tax return. The "ownership" and "use" requirements of this rule can be quite difficult in real life scenarios, depending on factors such as marriage, divorce, work related moves, home offices, and other facts that may or may not invoke various "safe-harbor" protections of the statute.

B. PRINCIPAL RESIDENCE

Although the statute does not define the term "principal residence", IRS guidance and regulations provide useful guidance. Whether a property qualifies as a "principal residence", in circumstances where the taxpayer has a single residence, or in when a seller uses more than one property as a residence depends on all of the facts and circumstances. Generally, the property used by the taxpayer for the majority of the year will be considered the "primary residence", but this "majority of time" rule could vary from year to year.

Under this rule, the property does not have to be the taxpayer's principal residence at the time of the sale. This is important, because a taxpayer has the ability to defer a sale and the resulting gain until the third year after moving out of the residence, if the first two years of the last five leading up to the day of sale satisfy the ownership and use tests.

C. OWNERSHIP AND USE

The requirements for "two years" of ownership and use merely require twenty four full months, or 730 days, at any time during the five year period ending on the date of sale. In other words, the ownership and use periods of time do not have to be concurrent or consecutive, so long as both can be met (or have accumulated) during the five years ending on the day of sale. Occupancy is the primary factor for determining "use" of the residence.

D. SPOUSES

Married couples are eligible to avoid tax on \$500,000 of gain from the sale of their principal residence if they meet four other factors:

1. A joint return is filed in the year in which the sale occurs;
2. At least one spouse meets the two year ownership requirement;
3. Both spouses meet the two year use requirement; and
4. Neither spouse has used the exclusion within the preceding two years.

E. BUSINESS USE

Partial use of a residence for a home office or other business use may cause the homeowner to lose part of the exclusion. Only the part of the gain allocable to the residential portion of the home is excludable. In addition, the exclusion will not apply to gain from the sale to the extent of depreciation claimed after May 6th, 1997.

F. CONCLUSION

This exclusion may be used every two years, and is not limited to one, \$250,000 lifetime "shield" for an individual (or \$500,000 for a couple). Also, a taxpayer may refuse to have the exclusion rules apply by simply filing a tax return in the taxable year of the sale, and including the gain from the sale in gross income. This would be desirable if a taxpayer makes two qualifying sales at a gain within a two year period and the gain on one of the sales is larger than the gain on the other.