Profits realized from the sale of a home can result in a big tax bill, but if you plan right, there are actions you can take to reduce, defer or eliminate the taxes.

Tax Planning Considerations for the Sale of Your Home

By Clarence C. Rose

The profit realized from the sale of a home can create a sizable tax bill for the homeowner if the tax laws allowing deferral or exemption of the gain are not carefully followed. Income taxes are levied on the gain from the sale of a personal residence by the federal government, by 44 states, and even by a large number of cities, and these taxes combined can exceed one-third or more of the gain realized if the homeowner allows the sale to be subject to taxation.

Fortunately, these taxes can be reduced, deferred, and possibly eliminated through careful planning. This article examines the actions necessary on the part of a homeowner under the existing tax laws to reduce, defer, or eliminate the taxes due on the sale of a home, with particular attention paid to the rules regarding exclusions for those over age 55.

Tax Planning and the Adjusted Basis

Careful tax planning on the part of a homeowner during the period of homeownership and at the time of sale can reap considerable tax savings. The IRS defines homeownership that may be treated as a primary residence to include a house, condominium, cooperative, mobile home, boat, or similar property that has sleeping space, kitchen facilities, and a bathroom.

The starting point for calculating the gain from the sale of a home is the determination of the property's adjusted basis. The original purchase price of the home, plus any closing costs associated with the home's purchase, is needed for calculating the basis. Some closing costs may be tax-deductible in the year of purchase, such as points and loan origination fees. However, only closing costs that are not deductible in the year of purchase are added to the purchase price for calculating the adjusted basis. The costs of any improvements made by the homeowner during the period of ownership are also added to the adjusted basis. Each homeowner should keep a copy of the settlement statement from the purchase of their home and a file that includes receipts for all improvements made during their period of ownership.

The gain from the sale of a home is often overstated because many homeowners fail to keep track of the original acquisition costs and improvements that can be added to the original purchase price of the home. An improvement to the home or landscape is a permanent betterment that adds to the value of the home, prolongs the life of the home, or changes the use of the property. Keeping all improvement receipts and the settlement closing statement from the home's purchase will help to reduce the taxes on the eventual sale of the home. Example of improvements include: room additions, remodeling, a new roof, putting in central air conditioning, and planting trees on your property. Additions to the basis reduce the amount of gain realized from the eventual sale of the home.

Possible other adjustments to the basis of a home include any deferred gain from a previous home sale, casualty losses that occurred during the period of ownership, and any depreciation deductions claimed against the home relating to business use of the home. The burden of proof for adjustments to the basis of a home are on the homeowner. Maintenance and repairs are not improvements and may not be used in the calculation of the adjusted basis. However, these expenses may qualify as fixing-up expenses if incurred within 90 days prior to the sale of the home. Proper documentation of adjustments with receipts will help ensure the full amount of legal deductions for the homeowner.

Calculating the Gain

The gain on the sale of a personal residence is the net proceeds received from the sale of the residence in excess of the adjusted basis. The net proceeds from the sale of a home is the selling price of the home less all selling expenses incurred by the homeowner and qualified fixing-up expenses. Selling expenses include real estate sales commissions, legal fees,

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and closing costs paid for by the seller (homeowner). Qualified fixing-up expenses include repair work performed on the home to make it more salable. In order to be deductible, fixing-up expenses must be for repair work performed during the 90-day period just prior to the day the sales contract was signed. Fixing-up expenses also must be paid within 30 days of the signing of the sales contract in order to qualify as a deduction.

For example, if a married couple purchased a home for $110,000 in 1985 and incurred $3,000 in acquisition costs, which are added to the basis, made capital improvements of $17,000 during their period of ownership, and in 1996 sell their home for $215,000 less selling expenses of $12,900 and fixing-up expenses of $1,100, their realized gain from the sale of the home is $71,000, computed as shown in Table 1.

Table 1.
Calculating the Gain on the Sale of a Home

Original Purchase Price of Home		$110,000
Plus: Closing Costs not Deductible in Year of Purchase	+	3,000
Plus: Total Costs of Improvements	+	17,000
Adjusted Basis		**$130,000**
Selling Price of Home		$215,000
Less: Total Selling Expenses	–	12,900
Less: Fixing-Up Expenses	–	1,100
Net Proceeds From Sale of Home		**$201,000**
Net Proceeds From Sale of Home		**$201,000**
Less Adjusted Basis	**–**	**130,000**
Taxable Gain or (Loss)		**$71,000**

The federal tax on the $71,000 gain would be $19,880 if the gain were not deferred or exempt ($71,000 × 0.28 = $19,880), assuming the couple has a marginal tax rate over 28%. The gain from the sale of a home, if subject to tax, is taxed at the taxpayer's marginal income tax rate or 28%, whichever is lower.

Deferring the Tax

A principal residence is likely to be the greatest source of net worth for an individual or married couple. A realized gain from the sale of a home that is not deferred or excluded is subject to tax as a capital gain to the homeowner. The current capital gains tax rate is 28% or the individual's marginal federal income tax rate, whichever is lower.

The gain realized from the sale of the home may be deferred for tax purposes if the homeowner replaces the sold residence by purchasing a home of equal or greater value within two years of the sale of the home. If these conditions are met, the realized gain is deferred and no tax is currently due. The gain realized from the sale of the residence is subtracted from the basis of the new home and deferred until the newly purchased home is sold.

For example, if a new home costing $275,000 is purchased after realizing a $71,000 gain from the sale of a residence, the basis of the new home is reduced by the $71,000 deferred gain.

Original Purchase Price	$275,000
Less: Deferred Gain	– $71,000
Adjusted Basis of New Home	$204,000

All other adjustments to the basis of the new residence are the same. As a result, any gain realized on a subsequent sale will be higher by the amount of the deferred gain. It is very important for homeowners to meet the two-year replacement time period for the purchase of a replacement home in order to defer the taxable gain. Otherwise, the gain is not deferred and the ex-homeowner will have a capital gains tax due.

The IRS does not grant extensions to the two-year time period for replacing a sold personal residence. Also, the homeowner must actually occupy and use the new home within the replacement period. If a homeowner purchases a replacement residence within the two-year period after selling the old principal residence, but does not actually occupy the new residence until after the expiration of the replacement period, no gain deferral would be allowed by the IRS.

The replacement time period for the sale of a residence begins two years before and ends two years after the sale of the old residence. Generally, only one gain deferral is allowed every two years unless the second sale is job-related. Also, if the homeowner purchases a replacement home prior to selling an old residence and then sells the new home before the sale of the old residence is complete, a capital gains tax would be due under these conditions for any realized gain.

If a homeowner sells his or her home and then buys a replacement home of lesser value with the intention of fixing up or remodeling the newly purchased home, the purchase price plus the costs of remodeling incurred during the two-year replacement period must be equal to or greater than the price of the home sold or a portion of the realized gain will be taxable to the homeowner. For example, if a homeowner sells his or her home that has an adjusted basis of $105,000, and receives net sales proceeds of $200,000, and the replacement home costs $185,000, the homeowner would realize a taxable gain of $15,000 ($200,000 less $185,000) and would defer a gain of $80,000 ($185,000 less $105,000). The basis of the new home is $105,000, computed as follows:

Purchase Price	$185,000
Minus: Deferred Gain	– $80,000
Adjusted Basis New Home	$105,000

The $15,000 taxable gain would be taxed at 28% or the homeowner's marginal income tax rate if lower ($15,000 × 0.28 = $4,200). Any improvements to the new home could be made within the two-year replacement time period to reduce the taxable gain.

Excluding the Tax for Homeowners 55 or Older

After a homeowner reaches age 55, the taxpayer may elect to exclude up to $125,000 of realized gain ($62,500 for married individuals filing separate returns) from the sale of a residence.

To exclude the gain, the taxpayer must be age 55 on or before the date of the sale and must have owned and used the home as a principal residence for at least three of the past five years ending on the date of the sale. A married couple owning their home jointly will meet the age and ownership use requirements even if only one spouse satisfies them.

The option to exclude the gain from the sale of a home is a once in a lifetime opportunity. Once elected, the taxpayer's decision cannot be changed, and the election to exempt *any* amount of gain from the sale of a residence uses up the entire $125,000 available lifetime exemption. Also, if a married couple elects to take advantage of the exclusion and later divorces, or if one spouse dies and the other remarries, *none* of the new couples can use the exclusion again.

Widowed homeowners over age 55 who plan to remarry have some additional tax planning considerations. It is not unusual for two individuals who are over 55 and who both own their own homes to wed, sell their separate homes, and buy a new home jointly. However, the timing of these transactions can have significant tax consequences. If each individual waits until after they are married to sell their respective homes, they will be treated as a married couple and will be limited to only one exclusion between them in the amount of $125,000. If either of the married persons had used the exclusion in a prior marriage, then no exclusions would be allowed for the new married couple.

If the individuals' intentions are to sell their respective separate homes and purchase a new home jointly, then in order to ensure that the individuals are able to claim the highest amount of tax deductions allowed, each should sell his or her home before marrying. In this situation, each individual would be eligible for the full $125,000 exclusion on the gain from the sale of their homes, provided they had not already used the once in a lifetime exclusion, or, if one individual had already used the exclusion in a prior marriage, the exclusion would be retained for the other individual. If they aren't married yet, each will be able to get the full $125,000 exclusion. Similarly, widows or widowers can claim the full $125,000 exemption provided that the age and use tests are met and no prior exclusion was claimed.

Normally, individuals and/or married couples should use the election to exclude the gain from the sale of a residence only when the amount of the gain is significant and/or there is only a remote possibility of ever purchasing another home. However, a tax planning consideration for older homeowners who intend to buy a retirement home of lesser value than their current residence would be to elect the exclusion option if the realized gain is significant and the price of the replacement home is considerably less than the sales price of the home sold. Thus, even though another home purchase is anticipated, the election to exclude may be a wise tax saving move.

For example, a homeowner over age 55 who owns a $300,000 home with an adjusted basis of $100,000 could sell and purchase a smaller, less expensive home or condominium for $175,000 or more and pay no capital gains tax if he or she elected the lifetime exclusion.

Net Selling Price	$300,000
Minus: Adjusted Basis	– $100,000
Gain	$200,000
Minus: Lifetime Exemption	– $125,000
Taxable Gain	$75,000

The $75,000 taxable gain on the sale of the home could be deferred by buying a home for $175,000 or more.

Salvaging a Tax Loss by Postponing a Sale

It is important to note that a loss on the sale of a home is not tax-deductible for the homeowner. If the sale of a home will result in a loss to a homeowner, the individual, if he or she is in a financial position to hold onto the property, may consider converting the home to income-producing property. There are many factors that may influence the financial soundness of a decision such as this. One factor of major importance for many property owners would be the ability of the home, if converted to income property, to generate a breakeven or positive cash flow from the rental income. An advantage to the property owner is the opportunity to claim depreciation write-offs, which would provide annual tax savings.

Converting a home to income-producing property should be viewed very carefully whenever there is the opportunity to defer or exempt a gain from the sale. Converting the home to income property will generally disqualify for gain deferral treatment on the subsequent sale of the old residence. Gain deferral on the sale of a home is available only if the home is the principal residence of the taxpayer.

Conclusion

Some basic tax planning on the part of a homeowner can reap considerable tax savings on the sale of a house.

Careful attention to the specific requirements is a must to preserve the available tax benefits.