

IRS HOME SALES RULES

No Tax on Home Offices – Amend Prior Years

Imagine that the IRS put *you* in charge of writing the regulations for avoiding taxes on the sale of your home. The new regulations are just like you wrote them for yourself with your own interests at heart.

In fact, we doubt you would have given yourself all the breaks that the IRS gave. That's how good the new regulations are!

Before getting to these magnificent breaks, let's review the basics. You can qualify to owe nothing to the IRS when selling your main home for a profit of up to \$250,000 or \$500,000. This is probably the most valuable tax-saving break on the books for individuals. To cash in, you must:

- own the home for at least two years out of the five-year period ending on the date of sale, and
- use the home as your principal home for at least two years during the same five-year period.

For husband and wife filing jointly, both must meet the use test, but only one has to meet the ownership test.

There's one other basic: if you exclude the gain from an earlier home sale, you generally must wait two years before taking advantage of the gain exclusion privilege again.

In late December of 2002, the IRS issued some of its final regulations on the \$250,000 and \$500,000 gain exclusions. It's about time. The home sale gain exclusions were enacted back in 1997. That said, the wait has been worth it. The new rules are very tax-payer friendly. You are going to love them! They are a classic case of "you can have your cake and eat it too."

Not only that, you can apply the new rules retroactively to reduce, even eliminate, taxes you paid in a prior year. We will cover retroactive application at the end of this article. But think of it: recovering taxes you already paid. That's a pleasant thought.

This article is full of good news. So let's move to those wonderful new home sale regulations.

Capital gains tax relief for sales of homes with inside offices or rentals

Under the new rules, if you sell a home that contained an office or rental inside the dwelling, you do not make any allocation of appreciation to the office part of your home. You may have some depreciation recapture tax (very minor) as we will cover shortly. But with an office inside the dwelling, you treat the appreciation of the sale of the home as if no office exists. Wow!

Example. Harry Miller bought his home 17 years ago for \$65,000. He used 21% of his home as an office and deducted that office on his tax return every year for 17 years. After making no improvements to the home for 17 years, Harry sells his home for \$565,000. Under the new rules, the Millers need not allocate any of the \$500,000 profit to the office. When Harry and his wife file their joint tax return, they may exclude the entire \$500,000 profit from taxation.

Could you have written a better rule? The old rules required Harry and his wife to pay capital gains taxes on \$105,000 of the appreciation (the 21% office part of the \$500,000 gain). But the new rules say that when the office is inside the dwelling, you do not allocate any profits to the office.

Suppose Harry and his wife sold that home two years ago? They would have paid capital gains taxes on the \$105,000. Now, with the new rules, Harry and his wife may amend that return and get a refund of the taxes they paid on the \$105,000 gain.

Generally, you can amend any of your last three years' tax returns. So, during the last three years, did you sell a home and pay taxes on the sale? If so, apply the new rules to that old sale and collect a refund.

The new rules are not perfect. Although you may exclude appreciation from taxation, you may not exclude home office depreciation taken after May 6, 1997. This is no big deal because:

- the capital gains tax rate of this recaptured depreciation is only 24% (far less than the usual benefit rate), and
- you do not pay the 24% recapture tax until you sell the home (thus, you also benefit by the time value of money).

Example. Betty Bestor is in the 43% tax bracket. This year, she claims \$1,000 in home office depreciation and that puts \$430 in her pocket. She takes this tax-refund money and invests it at 5%, after taxes. Ten years from now, when Betty sells her home, the original \$430 tax refund has grown to \$700. The sale of her home causes Betty to pay \$250 in depreciation recapture taxes (25% x \$1,000 original deduction). This is a good deal: pocket \$700, pay \$250, and make a profit of \$450.

The new rules apply only when the office or the rental is inside the dwelling. If the office is not inside the walls of the house, you do not get the big appreciation break. Instead, you pay taxes on the appreciation profits that you must allocate to the office.

For example, say that your condition is identical to Harry's above, except that your office is in a detached garage. You would owe tax on the \$105,000 of gain attributable to the office in the detached garage.

Planning tip for the detached office. Eliminate the detached office and make it part of your home two years before sale of your home! This way you pass the two-out-of-five years test for exclusion of gain.

For example, say that you eliminate the detached office and make it part of your home two years before you sell. When you sell, you pay no tax on the profits up to \$500,000, assuming you are married. You pay only the 25% depreciation recapture tax on the home office depreciation taken after May 6, 1997.

Let's say that you converted the basement of your home into a separate rental dwelling unit by installing kitchen and bathroom facilities and a separate entrance. When you sell the property, you must treat the sale as two separate transactions. Allocate your tax basis and sales proceeds between the basement and your home and calculate two separate gains.

You may not exclude the gain from selling the basement. It is a rental property. However, you may use the gain exclusions to cut the taxes on the home sale.

On the other hand, if you simply rented bedrooms in your primary residence, then, like Harry, you ignore the rental bedrooms when you sell the home. But, you do pay the depreciation recapture tax on sale of the rental bedrooms.

Before going to additional highly favorable rules, keep this one big break in mind: For purposes of the \$500,000 and \$250,000 exclusions, you may ignore any offices located inside your dwelling. No rules could be more favorable for you.

New rules make it easier to exclude gain when you have a premature sale of your home

What happens when you fail the two-year tests? For example, you might sell your home for a healthy profit after living there only 18 months, instead of the required two years. Or you might sell your current home less than two years after excluding gain from the sale of a previous residence. Must you pay tax on the entire gain when you make a "premature" sale?

You can probably avoid the taxes by claiming a reduced gain exclusion (less than the full \$250,000 or \$500,000 amount that would ordinarily apply). The new rules make it pretty easy for you to qualify for this reduced gain exclusion, as you will see.

Here is how you calculate the reduced gain exclusion. Your reduced gain exclusion amount equals the full \$250,000 or \$500,000 figure (whichever would otherwise apply to you) multiplied by a fraction. The numerator of this fraction is the shorter of:

- the aggregate time you owned and used the home as your principal home during the five-year period ending on the date of sale, or

- the time between the last sale for which you claimed an exclusion and the sale date for the home currently being sold.

The denominator is two years (or 24 months if you are doing the arithmetic in months). This is pretty easy stuff as you will see in the following two examples.

Say you and your spouse owned and used a home as your principal home for 11 months. Say further that you qualify for a reduced gain exclusion. Based on that 11 months, your reduced gain exclusion is \$229,167 [$\$500,000 \times (11 \text{ months}/24\text{months})$]. That should cover the profits you earned during that 11 months of ownership.

Say that you are unmarried, sold your previous home 15 months ago, and excluded the gain. Now you are about to sell your current home, which you've owned and used as your principal home for 21 months. Remember, the new rules limit your exclusion benefit to the shorter of the time in the home (21 months) or the time since your last home sale (15 months). Thus, you are entitled to a reduced gain exclusion of \$156,250 [$\$250,000 \times (15 \text{ months}/24 \text{ months})$]. The \$156,250 should be more than enough to avoid any federal tax bill from prematurely selling this home.

Planning Note. The gain exclusion you claimed on the sale of your previous home is completely unaffected by all of this.

The reduced gain exclusion is available only when your premature sale is primarily due to:

- a change in place of employment,
- health reasons, or
- unforeseen circumstances.

Here is another place where the new regulations are great. Before the new regulations, the IRS offered no guidance on a change in place of employment or health reasons. Even worse, the old regulations flat out prohibited you from claiming unforeseen circumstances as the reason for a premature home sale. The new regulations provide taxpayer-friendly rules that you can rely on for today's sales, tomorrow's sales – and past sales too, as explained at the end of this article. Again, thank your IRS for these wonderful rules!

How the new rules define and treat a change in place of employment.

The new regulations allow the reduced gain exclusion for the premature home sale which is primarily due to a change in place of employment for any qualified individual. This is a broad and friendly definition. To start, "qualified individual" means you, your spouse, any co-owner of the home, or any other person whose main residence is within your household.

A premature home sale is *automatically*, by regulation, “primarily due to a change in place of employment” if any qualified individual passes this distance test: The new place of employment is at least 50 miles farther from the residence sold than was the former place of employment. Also, you pass the distance test when the qualifying individual had no former place of employment and the distance between the individual’s new place of employment and the residence sold is 50 miles or more.

Say you run your sole proprietorship business out a deductible office in your home. You decide to sell the home, which you owned and used as your principal home for only 19 months. You then buy a new home 65 miles away. You again set up shop in a deductible office within your new home. Under these facts, you pass the 50-mile test. Why? Because your new place of employment (your new house) is 65 miles farther away from your former home than was your old place of employment (your old house which was zero miles away from itself). So you automatically qualify for the reduced gain exclusion.

If you are married, the reduced exclusion is \$395,833 [$\$500,000 \times (19 \text{ months}/24 \text{ months})$]. If you are single, the reduced exclusion is \$197,917 [$\$250,000 \times (19 \text{ months}/24 \text{ months})$]. In either case, the reduced exclusion probably covers any federal tax bill triggered by prematurely selling this home (except for the depreciation recapture tax on the home office).

Keep in mind that you do not have to meet the test. If any qualified individual meets the test, you meet the test. For example, say that your spouse has the office in the house, you qualify for the break because your spouse qualified.

What happens if no qualified individual passes the 50-mile test? Relax! The new regulations contain an alternative to automatic qualification. You may qualify for the reduced gain exclusion break if the facts and circumstances show that your premature home sale was primarily due to a qualified individual’s change in place of employment.

For example, assume your wife is an emergency room physician. She must be close to the hospital where she works; accordingly, your home is only three miles away. Then your wife gets a new job at a different hospital. As a result, you sell the home, which you owned and used as your principal home for only 22 months. You then rent a townhouse that’s only five miles away from your wife’s new job location. Let’s say her new job is 42 miles away from your old residence. In this case, you fail the 50-mile test because your wife’s new job is only 39 miles farther away from your old home than was the old job (42 miles less the three miles). However, due to the nature of your wife’s work, it’s quite clear she must live close to her place of employment. Here the facts and circumstances clearly show the premature sale of your former home was primarily due to a change in the place of your wife’s employment. Since she is a qualified person, you are eligible for the reduced gain exclusion privilege on your joint return. The reduced exclusion amount is \$458,333 [$\$500,000 \times (22 \text{ months}/24 \text{ months})$]. That should cover any tax on appreciation of the old home during this 21 month period.

Planning tip. If you can't pass the 50-mile test, keep documentation that proves your premature home sale was due primarily to a change in employment, either yours or that of another qualified individual.

How the new rules allow premature sale benefits for health reasons

Under the new regulations, you may claim the reduced gain exclusion privilege whenever the premature sale of your home is due primarily to health reasons. You pass this test when you must move to:

- obtain, provide, or facilitate the diagnosis, cure, mitigation, or treatment of disease, illness, or injury of a qualified individual, or
- obtain or provide medical or personal care for a qualified individual who suffers from a disease, illness, or injury

For this purpose, "qualified individual" means:

- you,
- your spouse,
- any co-owner of the home, or
- any person whose principal home is within your household.

In addition, the new regulations count almost any close relative of a person listed above as a qualified individual. Then, to make sure you have plenty of qualified relatives, the new regulations add any descendent of your grandparent (such as your first cousin) to this list of qualified individuals.

The new regulations *automatically* make the premature home sale primarily for health reasons when a doctor recommends a change of residence because of a qualified individual's health (meaning to obtain, provide, or facilitate health care, as explained above). Without the doctor's recommendation, your facts and circumstances must show your premature sale was primarily for reasons of a qualified individual's health. You may not claim the reduced gain exclusion when the premature sale is merely beneficial to the general health or well being of a qualified individual.

How the new rules define a premature sale due to unforeseen circumstances

In addition to the easy rules on moving and health, the new regulations multiply the possibilities for avoiding taxes on the sale of your home when your premature home sale is due primarily to unforeseen circumstances. In this case, you *automatically* qualify for the reduced gain exclusion if:

- your home is seized or condemned (such as by a government agency),
- your home is a casualty of a man-made disaster or act of war or terrorism,
- a qualified individual dies,

- a qualified individual becomes eligible for unemployment compensation,
- a qualified individual experiences a change in employment status or self-employment status that results in your inability to pay housing costs and basic living expense,
- a qualified individual is divorced or legally separated, or
- a qualified individual's pregnancy results in multiple births.

For this purpose, "qualified individual" means:

- you,
- your spouse,
- any co-owner of the property, or
- any other person whose principal home is within your household.

You may claim the reduced gain exclusion for a premature sale triggered by some other significant event that you did not anticipate before you purchased and occupied the home. For example, the regulations say a drastic increase in your condo association fees qualifies as an unforeseen circumstance.

How to claim the gain exclusion for sale of vacant land next to your home

The new regulations allow use of that valuable gain exclusion privilege to shelter profit from selling vacant land next to your principal home. In fact, you can even sell the parcel with your home and then the surrounding vacant land in completely separate transactions!

You qualify for exclusion of gain on the sale of vacant land when:

- the vacant land is adjacent to land that contains your principal home,
- you owned and used the vacant land as part of your principal home, and
- you sell the principal home within 2 years before or 2 years after the date of the sale of the vacant land.

When you pass all tests, you may exclude up to \$250,000 (\$500,000 if you file jointly) of combined profits from the sale of the parcel containing your house and the adjacent vacant land. The regulations say that you can sell a one-acre parcel with your home in one transaction and a 29-acre adjacent parcel of vacant land in a separate transaction – and then use your gain exclusion to shelter the combined profits from the two sales.

We could not have hoped for a better answer than this from the IRS!

What happens when you sell the vacant land before selling the parcel that contains your residence? Good question. Say you sell the vacant land in 2003 and the home in 2004. You report the land sale and its gain on your return for 2003. You also pay tax on that gain with your 2003 tax return. Then in 2004 when you sell the parcel containing your residence, you file an amended return to collect a refund of the taxes you paid on the sale of the land, plus interest.

Generally, you may amend your return anytime within three years from the date you send your return to the IRS. Do not procrastinate on this. File the amended return immediately so that you do not miss the deadline!

Planning Tip. Self-employed taxpayers who did not claim a home office should consider amending prior year returns to claim the home office.

In fact, even those who sold their homes during the last three years should consider amending for the home office and then taking advantage of the new “office inside the home” rules for excluding gain.

Summary and Conclusion

By now you should be excited by the new regulations. You could not have written a more beneficial set of rules. The new gain exclusion rules are truly a gift.

Now, you can avoid federal tax on home sale profits in circumstances where not even the most optimistic tax adviser dared to hope for relief.

In short, these rules are almost too good to be true. But they are true! They are from those folks at the IRS who write the regulations. Use them to your advantage.

If you have to file amended returns to cash in on your unexpected tax savings, do so now. Do not miss the deadline.

Feel free to contact Derek D. Simmons or Donald R. Laird at Watkinson Laird Rubenstein Baldwin & Burgess, P.C., at (541) 484-2277 in Eugene, (541) 673-5528 in Roseburg, (541) 923-8767 in Redmond, or (541) 757-1365 in Corvallis for further information.

