HOUSING COUNSEL

A lesson on real estate deductions

BY BENNY L. KASS

Third in a series

"People who complain about taxes can be divided into two classes: men and women."
— Unknown

Selling your home (including condo or co-op) in today's market is not easy, but when you are successful, you may be pleasantly surprised by the favorable tax laws.

In general, if you are married and meet two legal tests, you can exclude up to $500,000 of the profit you have made. If you are not married or file a separate tax return, the exclusion is reduced to $250,000.

The two tests are ownership and use. You must have owned and used the property for at least two out of five years before it is sold. If you are married and file a joint return, one spouse must meet the ownership and use tests to exclude up to $250,000 of the gain. However, if either of you meet the ownership test and both meet the use test, you can exclude the full $500,000.

The exclusion is generally applicable once every two years.

What if you have to sell before you can meet the two-year tests? You still may be eligible for a reduced exclusion. If, for example, you changed jobs and must travel at least 50 miles farther from the home you sold, and the primary reason for selling was because of employment, you would be eligible for a partial exclusion of gain.

If you sold mainly because of health-related issues, you may be eligible for a partial gain exclusion. In Internal Revenue Service regulations "health" includes "the diagnosis, cure, mitigation or treatment of disease, illness or injury." If your doctor recommends a change of residence for one of these reasons, you will automatically qualify for the partial exclusion.

There is, however, a third category, called "unforeseen circumstances." Each of us — at one point in time — will face conditions that could not have been anticipated, conditions that significantly affect our lives and our wallets. It would be unfair when confronted with such a crisis to have to sell your house before the two years are up and have to pay the full capital gains tax.

Accordingly, the IRS has issued regulations, listing several "safe harbors," including:

- involuntary conversion of the residence — for example the government condemned it;
- natural or man-made disasters, acts of war or terrorism;
- death of one of the owners;
- divorce or legal separation.

How do you calculate this partial exclusion? You multiply the maximum allowable exclusion (either $250,000 or $500,000) by a fraction; the numerator is the number of days used and the denominator is 730 days (note that 730 days is two years).

While the up-to-$500,000 exclusion looks good on paper, many Washingtonians who bought their homes many years ago will find that they have made a large profit.

The exclusion law applies to principal residences, whether they be single-family homes, cooperative apartments or condominium units. If your boat or mobile home has sleeping quarters, a toilet and cooking facilities, it will also qualify for the exclusion.

How do you determine profit? Oversimplified, you take the selling price, deduct selling expenses (such as commissions, advertising and legal fees), and get the "amount realized." Then you deduct the adjusted basis to determine your gain (or loss). Adjusted basis is the price you paid for your house, add closing costs, then add any major improvements. If your spouse died since you bought the property, you will have to include the stepped-up basis, but discuss this issue with a lawyer.

So while the up-to-$500,000 exclusion looks good on paper, many Washingtonians who bought their homes many years ago will find that they have made a large profit — often considerably more than the $500,000 they can exclude. Any profit over and above the exclusion is taxed at the capital-gains rate; the federal tax rate today is 15 percent. Plus, any applicable local or state tax must be paid on the profit.

There are many special circumstances that the IRS has to address. For example, if you bought your home in 2008 and claimed the tax credit for first-time home buyers, you must repay the credit over a 15-year period. If you sell the home (or if it ceases to be your principal residence) you must repay any outstanding balance of the credit. This only applies to purchases in 2008; Congress changed the law the next year.

Another situation: your spouse dies and you want to sell the house. If you meet the following requirements, you may qualify to exclude up to $500,000 of any gain: the sale takes place after 2008; the sale took place no more than two years after the death; you have not remarried; you and your spouse met the use test at the time of death; you or your spouse met the ownership test at the time of death; and neither parties excluded gain from another home during the two years before the death. But once again, you must take advantage of the stepped-up basis, which will increase your basis and thus lower your gain.

The IRS has two helpful publications, "Selling your Home," publication 523, and "Tac Guide 2011," publication 17, both of which are available at irs.gov/publications.

You must keep all of your records, including settlement statements, home improvement invoices, and legal and title costs. Should you be audited by the IRS, the burden will be on you to prove that you did, in fact, make those payments.

Next: Starker (Section 1031) Exchanges.

Benny L. Kass is a Washington lawyer. This column is not legal advice and should not be acted upon without obtaining your own legal counsel. For a free copy of the booklet "A Guide to Settlement on Your New Home," send a self-addressed stamped envelope to Benny L. Kass, 1050 17th St. NW,