Deliberating Deductions

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Learn how you can exclude up to $500,000 of gains when selling your primary residence.

With real estate prices in San Francisco rising, we often find people asking us for advice on selling and buying property. The most common question is: how can I save money on taxes when I sell my property? The "last good loophole," according to my college taxation professors, is to sell your home. Selling your principal residence allows you to exclude up to $250,000 of gain from your taxable income, or $500,000 if you are married, filing jointly. That's nothing to laugh at, even if you are in the Bay Area. In fact, that $500,000 could be what you need for a down payment on a new property.

The formula used to calculate gain for tax purposes is: Sales Proceeds – Basis of Property = Gain. ("Sales Proceeds" is the amount for which the property sold, and "Basis of Property" is what you paid to purchase and improve the property.) The gain exclusion applies to selling your *principal* residence. How is "principal residence" defined? IRS Publication 523 states, "To exclude gain you, in most cases, must have owned and lived in the property as your main home for at least 2 years during the 5-year period ending on the date of sale."

The publication lists several additional factors that might help determine that this was your primary residence, such as location of: your family members' main home, your place of employment, your primary bank and/or recreational clubs/religious organizations of which you are a member. Other factors that can be taken into account are the addresses listed on your personal bills, driver's license, tax returns or car registration. These details demonstrate that the IRS will look at more than just your filing status and stated address when permitting the exclusion.

Since excluding the gain is an effective way to retain more of the profit you earn, it is essential to keep the necessary documentation in order to prove both that the property is your primary residence and to substantiate the basis of the property—thereby avoiding unpleasant surprises from taxing authorities. It is not uncommon for the IRS to examine the calculations on sales of a primary residence. If they challenge an item and propose a change to the tax return or the gain calculation, the burden of proof will be on the taxpayer to provide support for the basis of the property, or to prove that this was in fact their principal residence that they owned and lived in for at least 2 of the last 5 years.

Ownership and Use Tests

In order to claim the gain exclusion, there are two tests that need to be met: the seller must have owned the home for at least two years (Ownership Test) and have lived in the home, as their main home, for at least two years (Use Test).

Meeting these two tests will allow you to claim the exclusion of $250,000. But how does one cross the threshold to exclude the $500,000? At first glance it appears that all that needs to be done is to go down to city hall and sign a few marriage documents. This wishful thinking occupies many tangential conversations among tax professionals and students in taxation classes, looking for creative ways to reduce taxable income by $500,000.

Unfortunately, the IRS does put some restrictions on married couples regarding the additional exclusion. The Internal Revenue Code does allow the exclusion if either spouse passes the ownership test but requires that *both* spouses meet the use test. This can cause a missed tax break for couples who sell their home within two years of getting married.

In a rising market, it is not uncommon for individuals to "flip" houses for tax-free gains as their primary source of income. In order to limit situations such as these, the Internal Revenue Code requires another test. The additional test that must be met is the "no exclusion in the prior two years" test. If either spouse used the exclusion during the two-year period ending on the date of the sale of the new property, then you lose the extra $250,000.

Nonqualified Use

The gains mentioned above can be excluded from taxable income unless they fall into a category called "nonqualified use." A typical example of nonqualified use of a property is converting the property into a rental or using a portion of the property as a rental. This will provide the owner of the property certain benefits, including depreciation of the building. The benefits, however, do come with a downside.

Selling a home that has been partially depreciated will cause you to run into a little villain called depreciation recapture. What is depreciation recapture, you ask? When a property is depreciated for tax purposes, the IRS is allowing you to take noncash deductions to reduce your taxable income. The depreciation reduces the basis of your property. This, in turn, would increase your gain.

What happens when you have a large gain on the sale of your main home, but the property was previously depreciated? Is the gain excludable up to $250,000 (or $500,000)? The gain would qualify for exclusion, but the portion of depreciation from nonqualified use is recaptured and tax would be due on that portion of the gain.

This is not a hidden or extra tax. The IRS allowed you to reduce your taxable income by the amount of depreciation. In effect, you have already taken advantage of this deduction. If the IRS would allow the entire gain to be excluded, including the portion allocated to nonqualified use, you would be double-counting the deduction.

Another common type of nonqualified use is a home office. Having a home office can help a self-employed individual reduce his overall tax liability by deducting business expenses that are incurred as part of a home office deduction. One of the allowed deductions is depreciation. That's right. You take the portion of the home that you use exclusively for business purposes and you can depreciate it over 39 years like you would a business property. Only the portion of the property allocated to the building can be depreciated. Land is not considered depreciable property. Other home expenses like utilities, property taxes and mortgage interest can be prorated and deducted against business income as well.

More on Rentals

We have encountered clients who have chosen to take advantage of rising rent prices. They often rent out a portion of their house or move into a smaller apartment and rent out their primary house. This was an effective way for them to bring in some extra cash. Additionally, renting out a property allows you to deduct expenses related to the rental or prorate expenses allocated to the rental portion of the building, such as utilities, property taxes and mortgage interest, and offset them against your rental income.

You may decide to continue to live in the house and rent a portion of it out or convert the entire property into a rental. These strategies have their benefits and consequences.

When renting out a portion of your main home, such as a single room, the gain that you recognize on the sale of your residence will be excludable, but the depreciation that was deducted during the rental period will have to be recaptured. This will create a tax liability independent of the exclusion.

Converting a personal property to a rental property can be beneficial if you intend to sell the property while the property is worth less than what you paid for it. A loss on the sale of a personal residence is not deductible for tax purposes. A loss on the sale of a rental property, however, is deductible. In order to deduct the loss, you will need to prove that the property was in fact converted into a rental property. If the property was just temporarily rented out while the owner was looking for a buyer, the loss on the sale of the property would not be deductible.

Reduced Exclusion

Certain individuals come into unfortunate life situations that would prevent them from maintaining their current standards of living. If a client fails to meet the requirements for the exclusions, the first thing we tell them is, do not panic. There are additional provisions that can allow you to qualify for a reduced exclusion.

Generally, the reduced exclusion is for individuals who fail the ownership and use tests as well as individuals who have used the exclusion within the past two years. Changes in place of employment, changes in health and other unforeseen circumstances, including unemployment, divorce and death, among others, are situations that can qualify one for the reduced exclusion. Please see your tax professional regarding the formula for calculating the reduced exclusion in each individual case.

I hope the above information helped reinforce that there are nuances in tax laws. But you don't need to personally stay on top of the new law and changes—that is why you have a CPA. Working with your CPA regarding planning for the future will help you avoid unexpected surprises when dealing with tax authorities.

Owning real estate is a big achievement and a big responsibility. Taking the proper steps necessary and working closely with your trusted tax advisor allows you to take advantage of rising and falling real estate markets. Being proactive regarding tax planning can help legally minimize your tax liability. The main points you need to keep in mind are: keep your receipts, statements and other documentation; stay educated and keep your head out of the sand; and work with your tax professional to meet your tax planning goals.

The above information is intended as a summary of general principles of gains on sale of principle residence properties. All taxpayers are encouraged to seek guidance from their tax advisor to create a tax strategy that fits their unique situation. Alexander Goldshteyn is a tax specialist and advisor at Shwiff, Levy & Polo, LLP, and can be reached at 415-291-8600, ext. 234.