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Sale of Residence

An individual may exclude from income up to $250,000 of gain ($500,000 on a joint return in most situations) realized on the sale or exchange of a residence. The individual must have owned and occupied the residence as a principal residence for an aggregate of at least two of the five years before the sale or exchange. The exclusion may not be used more frequently than once every two years.

This exclusion has replaced the rollover of gain provisions and the one-time $125,000 exclusion for taxpayers age 55 or older. The required two years of ownership and use need not be continuous. The test is met if the individual owned and used the property as a principal residence for a total of 730 days during the five-year period before the sale.

The amount of excludable gain is $500,000 for married individuals filing jointly if:

1. either spouse meets the ownership test;
2. both spouses meet the use test; and
3. neither spouse is ineligible for exclusion by virtue of a sale or exchange of a residence within the last two years.

The exclusion is determined on an individual basis. Thus, if a single individual who is otherwise eligible for an exclusion marries someone who has used the exclusion within the two years prior to the marriage, the newly married individual is entitled to a maximum exclusion of $250,000.

An individual who fails to meet the two-year ownership and use requirements due to a change in place of employment, health, or unforeseen circumstance can prorate the maximum exclusion. The prorated exclusion is equal to $250,000 or $500,000 exclusion multiplied by the ration of:

1. The shorter of (a) the aggregate periods that the property was owned and used as a principal residence during the five-year period ending on the date of sale or exchange or (b) the period after the date of the most recent prior sale or exchange to which the exclusion applied, over two years.

Example 1. Al Jackson is an unmarried taxpayer who owned and used a principal residence for 23 months and then sold it in 2001 because of a change in his place of employment. He realized a gain of $50,000 on the sale of the home. He may exclude the entire $50,000 of gain because it is less than $125,000 (one-half of his maximum exclusion of $250,000).

In order to determine the gain or loss on the sale of a home, the individual must be able to determine the selling price, amount realized, and adjusted basis. The selling price of a home is the total amount received. This includes cash, notes, debts assumed by the buyer and fair market of services or property received. The amount realized is selling price, less selling expenses, such as commissions, legal fees and advertising. Adjusted basis refers to the individuals original basis in the home, usually cost, plus such costs as capital improvements, and less such items as depreciation claimed. The amount realized minus the adjusted basis results in the individual's realized gain or loss. A loss on the individual's main home cannot be deducted.

Sale of Rental Property

Gain or loss is usually realized when property is sold or exchanged. A gain is the amount you realize from a sale or exchange of property that is more than its adjusted basis. A loss is the adjusted basis of the property that is more than the amount realized.

You use Form 4797 to report gain or loss from a sale, exchange, or involuntary conversion of property used in your trade or business or held for the production of rents or royalties.

When reporting the sale of rental property, you are required to make adjustments to your basis for allowable depreciation regardless to whether or not it was taken.

Depreciable real property is subject to depreciation recapture under Code Sec. 1250. Gain on the sale or other disposition of Sec. 1250 property is treated as ordinary income rather than capital gain to the extent of the excess of post-1969 depreciation allowances over the depreciation that would have been available under the straight-line method.

Special recapture rules phase out the recapture by reducing it by 1% for each full month the property is held over a specified period in the case of (1) residential rental property, (2) certain types of subsidized housing, and (3) Code Sec. 1250 property for which rapid depreciation of rehabilitation expenditures was claimed. Form 4797 is used to calculate the amount of recaptured depreciation.

Long-term capital gain for the sale or exchange of depreciable real property that would be treated as ordinary income if the property were depreciable personal property is taxed at a maximum rate of 25%. The balance of the long-term gain is taxed at 20%. Unrecaptured 1250 gain is gain up to the amount of any depreciation taken. Depreciation in excess of straight line on real property is recaptured as ordinary income first before the above 25% and then 20% rates are applied.

The new rates and holding periods apply for payments received after May 6, 1997. If part of the capital gain from an installment sale if from unrecaptured section 1250 depreciation at the 25% rate, the taxable portions of the payments received are considered first to be from it. Once all of the unrecaptured depreciation is taxed, the balance of the payments are taxed at the lesser 20%/10% rate.

Complicated indeed, even for the professionals; so please, if you have any questions about the sale of your residence or the sale of rental property, visit our site – http://www.taxlogic.com.