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by **Jerrold J. Stern**

home sale rules eased

***TAXPAYERS WHO LOSE** a home because of a casualty event such as fire are eligible for the tax-free gain exclusion under the relaxed rules.*

Tax rules for home sales have been liberalized by the U.S. Department of the Treasury. The new rules relax restrictions on homes used partially for business, homes sold because of "unforeseen circumstances" and the separate sale of land near the home. No changes have been made to the dollar amount of maximum tax-free gain on the sale of a principal residence, which is $500,000 for joint filers and $250,000 for single individuals.

Separate Sales of Principal Residence, Adjacent Land

A homeowner living on a large lot or on substantial acreage may sell part of the land separately from the rest of the land and the residence. The gain on the land sale is eligible for the $500,000/$250,000 gain exclusion if the residence is sold within two years before or two years after the land sale. The exclusion applies to the total gain from the land sale plus the gain from the remaining land and residence sale as long as the land was owned and used as part of the principal residence for at least two of the five years preceding the sale.

For example, a number of years ago, married couple Bob and Celia purchased a home and 15 acres. In June of Year 1, they sold ten acres resulting in $100,000 of gain. In May of Year 3, the house and remaining five acres were sold, generating gain of $275,000.

The couple will have to pay a maximum 15 percent capital gains tax on the $100,000 land gain for Year 1 ($15,000 tax). However, when they file their Year 3 tax return, they can file an amended return for Year 1 and receive a refund for the $15,000 tax paid (without interest). Their Year 3 tax return would indicate a total gain of $375,000 ($100,000 plus $275,000).

Because the total gain is less than $500,000, all of it is excludible. If the gain on the house and the remaining five acres had been $475,000, only $25,000 of the gain on the ten-acre sale would have been excludible ($500,000 maximum exclusion less $475,000), generating a refund of $3,750 (15 percent of $25,000). Finally, if the house and five acres were sold before the ten acres were sold, no tax would ever be paid on the first $500,000 of total gain.

Homes Used Partially For Business or Rental

Some taxpayers use parts of their homes for business or rental purposes. The most common example of business use is a room that qualifies as a home office for tax purposes.

What happens when the home is sold? Under the new rules, the $500,000/$250,000 gain exclusion does not apply to the portion of gain that represents depreciation deducted on the business/rental part of the house since May 6, 1997. The balance of the gain can be excluded. The new rules provide much-needed clarity regarding calculation of taxable gain in these circumstances.

Paula is an attorney and uses one of the rooms in her house as a law office. Assume the home was purchased in 1998 and the office qualifies as a home office for tax purposes. Paula has deducted a total of $6,000 in depreciation on the home office since its purchase. The home is sold at a gain of $20,000. Only $6,000 of the gain is taxable. Paula's $250,000 gain exclusion shields the balance of the gain from tax. The tax rate is 25 percent, resulting in $1,500 tax (25 percent of $6,000).

Homes Sold Due to 'Unforeseen Circumstances'

For the $500,000/$250,000 gain exclusion to apply, the home must be owned and used by the taxpayer as a principal residence for two years or more during a five-year period ending on the date of sale. The new rules provide several exceptions that allow taxpayers to qualify for the full amount of the exclusion even if this requirement is not met. The exceptions apply to taxpayers:

- whose residences are lost through a casualty event such as fire or earthquake,
- who are forced to live in a facility for health reasons,
- who are involved in a divorce or
- whose spouses have recently died.

There are also conditions under which taxpayers who do not qualify for the full $500,000/$250,000 exclusion may qualify for a partial exclusion.

As illustrated here, the tax rules for sales of principal residences contain a variety of complexities. Consultation with a tax accountant or tax attorney is recommended.

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