A Reprint from *Tierra Grande*

Enhanced Home Sale Rules

By Jerrold J. Stern

Tax rules for home sales were greatly enhanced in 1997 and have been improving ever since. Several new IRS rulings illustrate the agency's continuing willingness to accommodate taxpayers by allowing partial tax benefits for homes sold "early" because of "unforeseen circumstances."

The maximum tax-free gain on the sale of a principal residence is $500,000 for joint filers and $250,000 for single individuals. To qualify for the $500,000/$250,000 gain exclusion, two conditions must be met.

1. The home must be owned and used by the taxpayer as a principal residence for two or more years during a five-year period ending on the date of sale.
2. The taxpayer must not apply the gain exclusion to any other principal residence sale during the previous two years.

Several exceptions enable taxpayers to qualify for a partial exclusion even if one of the conditions is not met. A partial exclusion is allowed if the reason for failing to meet the condition is "unforeseen circumstances" or "a change in employment or health" as defined by the tax law.

For example, assume Ann lives in Austin and finds new employment in College Station. She sells her Austin residence for a gain of $10,000 after owning it for 18 months. She fails to meet the first condition because 18 months is less than 24 months (two years). However, the "change of employment" exception allows her to receive a portion of the exclusion based on the 18 months she held the property in relation to the required 24 months.

She can exclude $7,500 of gain from tax ($10,000 × [18 months ÷ 24 months]). The remaining $2,500 is a long-term capital gain, taxed at either 15 percent or 0 percent, depending on the amount of Ann's other income. Had she owned and lived in her Austin principal residence for two or more years the entire $10,000 gain would be excluded.

Unforeseen Circumstances

The tax law considers a principal residence sale to be motivated by unforeseen circumstances if the primary reason for the sale is an event the taxpayer could not reasonably have anticipated before purchasing and occupying the residence. Examples include casualty events (such as fire or earthquake), divorce, or death of the homeowner or the homeowner's spouse.

The following examples illustrate qualified unforeseen circumstances.

Criminal Activities

Bill and Jane move to Badtown because of Bill's new job. A few months later, they become aware of criminal activities occurring in their neighborhood. Their son is assaulted and threatened. Three weeks later, Jane is assaulted by several neighbors and ends up in the hospital emergency room. Because of the assaults and the dangerous nature of the neighborhood, Bill and Jane sell their home and move elsewhere.

School Transportation

John and Sarah marry and purchase a new home outside Sarah's children's school district. For the children to continue to attend the same schools, they must provide their own transportation. Sarah's oldest child is able to drive the other children to school until she graduates. At that point, the family moves to a home located in the school district serving Sarah's school-aged children.

Retirement Community

After living in California for 40 years, Rob and Lauren sell their home and move to an age-restricted retirement community near San Antonio. One year later, their daughter loses her job and divorces her husband. The daughter's changed financial and marital situation make it necessary for her and her son to live with Rob and Lauren. However, age restrictions do not allow this. Rob and Lauren sell their home and relocate to Houston.

The benefits and flexibility in the home sale rules are attractive, but the requirements and calculations can be complicated. For specific advice, consult with a tax accountant or tax attorney.

Dr. Stern (stern@indiana.edu) is a research fellow with the Real Estate Center at Texas A&M University and a professor of accounting in the Kelley School of Business at Indiana University.

THE TAKEAWAY

Several new IRS rulings accommodate the needs of taxpayers who sell their homes "early" because of "unforeseen circumstances."

MAYS BUSINESS SCHOOL

Texas A&M University
2115 TAMU
College Station, TX 77843-2115

http://recenter.tamu.edu
979-845-2031

Tierra Grande (ISSN 1070-0234) is published quarterly by the Real Estate Center at Texas A&M University, College Station, Texas 77843-2115. Subscriptions are free to Texas real estate licensees. Other subscribers, $20 per year. Views expressed are those of the authors and do not imply endorsement by the Real Estate Center, Mays Business School or Texas A&M University. The Texas A&M University System serves people of all ages, regardless of socioeconomic level, race, color, sex, religion, disability or national origin.