TAX REPORT | By Laura Saunders

Will Your Home Sale Be Tax-Free?

After years in the doldrums, housing markets are heating up in many parts of the country. That makes it a good time review the taxes—and the tax breaks—on home sales.

"Home sellers get some of the best breaks in the tax code, and often no federal tax is due," says Julian Block, an attorney in Larchmont, N.Y., who has written many tax guides, including one for people selling their homes.

Yet Uncle Sam's largess in this area is quirky. For example, the sale of a boat that you live in could be tax-free, but profits on the sale of a second or third home are taxable. People often misunderstand the rules, says Melissa Labant, a tax specialist at the American Institute of CPAs. Here is what sellers and sellers-to-be need to know.

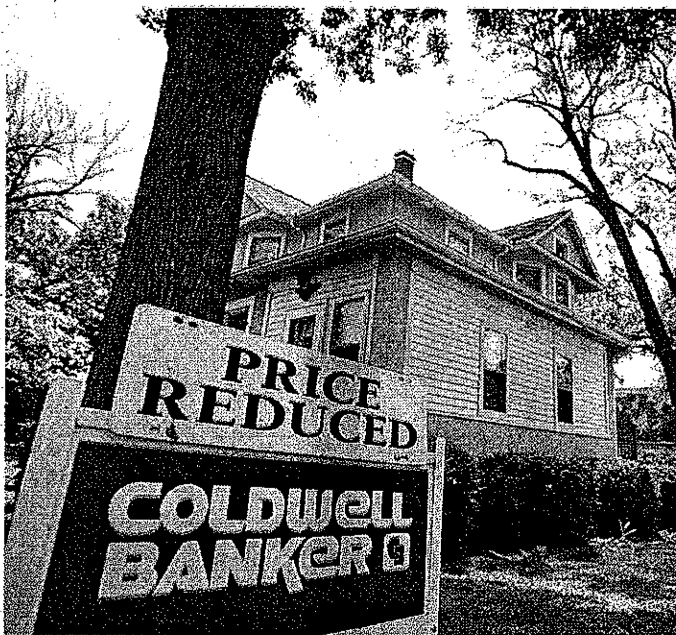
◆ **The principal-residence tax break.** Since 1997, sellers of a principal residence have been allowed to skip tax on a large chunk of their gain—up to $500,000 for married couples filing jointly and up to $250,000 for singles. Profits above those cutoffs are usually taxed as long-term capital gains. The current effective top rate on such gains is now almost 25%.

Note that this benefit applies to *profits* on a sale, which excludes the cost of the home and any improvements (see below). Say a couple bought a home for $200,000 in 2000 and spent $100,000 on improvements such as an extra room and landscaping.

Their cost basis, as it is called, would be $300,000, so between that and the $500,000 break, they could sell the house for as much as $800,000 without owing federal tax.

"For most homeowners in most markets, this benefit is all they need," Ms. Labant says.

Homeowners can claim this break as often as every two years. To qualify, they must have lived in the home for at least two years out of the previous five. (Short absences, such as for a vacation, aren't an issue.) A residence needn't be a free-standing house; it can be a duplex, condominium, or even a boat or mobile home, as long as it has eating, sleeping and toilet facilities. It can even be outside the U.S.



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A house for sale in LaSalle, Ill.: Sellers can often reap big tax breaks.

Special rules apply in some cases. For surviving spouses, there is an especially useful provision: Widows or widowers often retain the $500,000 exclusion if they sell their residence within two years of their partner's death.

If sellers don't meet the two-year requirement but have to move because of a change in employment, health (such as moving to a new school district for a special-needs child) or other unforeseen circumstances (such as a death or divorce), a reduced exclusion is available. See IRS Publication 523, "Selling Your Home," or get expert help.

Sellers who didn't owe tax on residences bought and sold before 1997 because of prior tax rules could have to adjust their cost basis downward to reflect the earlier tax deferral, Mr. Block says.

What if your vacation home becomes your first home? Complicated rules can apply when you sell it. The break is often prorated depending on how long it has been your primary residence, he says. Expert help might be a good idea here as well.

◆ **Rental unit in the home.** Does your residence have a rental unit, such as a garage apartment, that you have let to tenants?

Tax rules require that you divide the property into the percentage that is your residence and another that is the rental unit and treat them separately. Only the residence portion qualifies for the $250,000/$500,000 tax break.

◆ **Repairs versus improvements.** Although the principal-residence break wipes out taxes for many home sellers, experts say it still is a good idea to track improvements that can be added to the purchase price of your home.

In general, routine repairs—such as repainting, fixing gutters or replacing a broken window—don't count.

Renovations and additions, though, count as improvements, as would a new roof, a satellite dish or a new central air-conditioning system. For a more complete list, see IRS Publication 523.

◆ **The new 3.8% tax.** This year brings a new 3.8% tax on net investment income for most couples with adjusted gross income above $250,000 ($200,000 for singles). Although this tax can apply to gains on the sale of a home, it probably won't in all but the priciest markets, such as New York and San Francisco.

In cases where the gain is greater than the home's cost, plus improvements, plus the $250,000/$500,000 break, the tax will affect only the amount above the benefit—but capital losses can be used to offset such gains, if they are available.

◆ **Sales at a loss and forgiveness of debt.** While gains on sale of a residence can be taxable if they are large enough, losses aren't deductible because the home counts as personal property. Special rules allowing deduction of losses can apply if you turn the house into a rental property.

If a lender forgives mortgage debt, ordinarily the amount forgiven would be treated as taxable income. However, in 2007 lawmakers exempted up to $2 million of forgiven debt per taxpayer from this provision. The exemption lasts through 2013. Taxpayers can claim it on IRS Form 982; a few exceptions apply.

◆ **Home-office recapture.** If you took depreciation deductions for a home office, you will have to adjust the cost basis of the house downward to reflect them. In addition, the sum of the deductions taken after May 6, 1997, will be taxed when you sell the home. The rate could be as high as 25% (plus the 3.8% surtax, if you owe it), according to Mr. Block.

◆ **Home-buyer tax-credit recapture.** Congress passed two versions of a tax break that applied to certain home buyers for the years 2008, 2009 and 2010. Both versions have provisions that claw back some of the benefit if the home is sold ahead of schedule. For more information, see IRS Form 5405. Taxpayers often forget to make the adjustment on their returns.

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