principal residence sale and rental

A principal residence may be one of the most tax-efficient investments you can own since you can exclude as much as $500,000 of the gain on its sale.

The sale of your principal residence is eligible for an exclusion of capital gain up to $500,000, if you file as a married filing jointly and meet the tests listed below (other taxpayers can exclude up to $250,000 of the gain). Any portion of the gain attributable to a home office or rental use is not eligible for the exclusion.

PASS THESE TESTS AND EXCLUDE UP TO $500,000 OF YOUR GAIN

To qualify for the full amount of the exclusion, you must meet all of the following conditions:

- Have owned your principal home for at least 2 years. Your principal residence can be a house, houseboat, mobile home, cooperative apartment or condominium. The 2-year rule may consist of 24 full months or 730 days. If you are filing a joint return, only one spouse need qualify in order to benefit from the exclusion of at least $250,000.
- Have used the home as your principal residence for at least 2 years, in the aggregate, during the 5-year period ending on the sale end date.
- Did not exclude the gain on a home sale within the last 2 years.
- Did not acquire your home through a like-kind exchange (also known as a 1031 exchange) during the past 5 years.

With regards to principal residence, occupancy of the residence is required. Short temporary absences, such as for vacation or other seasonal absences, even if the property is rented during such temporary absences, will be counted as periods of use.

A pro-rata exclusion is allowed if you fail the above tests as a result of a hardship, which includes a change in employment, health reasons, multiple births from the same pregnancy, divorce or legal separation, or other unforeseen circumstances and natural disasters. The pro-rata exclusion is generally equal to a fraction, the numerator of which is the number of months you used and owned the house as your principal residence within the past 2 years and the denominator is 24.

A reduction of the exclusion is required to the extent that any depreciation was taken after May 6, 1997 in connection with the rental or business use of the residence, unless there was a separate structure for the rental or business use. Regardless, there will be a taxable gain which equals to the amount of depreciation previously deducted and it will be taxed at a special 25% capital gain rate.

DO NOT ASSUME YOU CAN ALWAYS SELL YOUR HOUSE TAX-FREE

Many people mistakenly think that you can defer a gain from the sale of a principal residence if they buy a new home that costs more than the selling price of the old home. That law was repealed many years ago (in 1997, to be exact). Under current law, you will have to pay taxes to the extent that a net gain exceeds the maximum exclusion amount allowed. Here is an example for a married couple filing jointly and meeting all tests:

Net proceeds on sale	**$2,000,000**
Tax basis (including capital improvements)	**600,000**
Net gain on sale of home	**1,400,000**
Allowable exclusion	**(500,000)**
Taxable gain	**900,000**
2016 federal tax at maximum 20% capital gain rate and the 3.8% Medicare Contribution Tax on net investment income	**$ 214,200**

Notes: *This gain may be subject to state income taxes. See the chapter on state tax issues.*

The taxable gain will be subject to the 3.8% Medicare Contribution tax on net investment income. The excludable gain ($250,000/500,000) is not subject to this tax.

NO EXCLUSION ALLOWED FOR NONQUALIFIED USE OF PROPERTY

Beginning with sales or exchanges of your principal residence after December 31, 2008, you will no longer be able to exclude gain allocated to periods of nonqualified use of the property.

Generally, nonqualified use means any period after 2008 where neither you nor your spouse used the property as a principal residence. To figure the portion of the gain that is allocated to the period of nonqualified use, multiply the gain by the following fraction:

Total nonqualified use during period of ownership after 2008, divided by total period of ownership.

A period of nonqualified use does not include:

- Any portion of the 5-year period ending on the date of the sale that is after the last date you (or your spouse) use the property as a principal residence.
- Any period (not to exceed an aggregate period of 10 years) during which you or your spouse are serving on qualified official extended duty as a member of the uniformed services or foreign services of the United States, or as an employee of the intelligence community.
- Any other period of temporary absence (not to exceed an aggregate period of 2 years) due to change of employment, health conditions, or such other unforeseen circumstances as may be specified by the IRS.

SPECIAL CONSIDERATION FOR THOSE WHO FILE JOINT RETURNS

If you are married filing jointly, things can get a little more complicated if you want to be eligible for the maximum exclusion of $500,000. While either you or your spouse can meet the 2-year ownership test, the following rules apply to the use test and "no exclusion in prior 2 years" test:

- Both you and your spouse must meet the 2-year use test. If only one spouse meets the test, the exclusion is limited to $250,000.
- Both you and your spouse must meet the "no exclusion in prior 2 years" test. This can be an issue if you sell your home, claimed an exclusion of $250,000, marry a homeowner and then jointly sell that home within 2 years. If the spouse meeting the test is the homeowner, he or she will still be eligible for the $250,000 exclusion, and the spouse failing the test is not eligible for a pro-rated exclusion, unless the hardship rule applies, as discussed above.

SALE BY SURVIVING SPOUSE

A surviving spouse who has not remarried and sells a principal residence within 2 years from the date his or her spouse died can exclude $500,000 of gain rather than $250,000.

KNOW YOUR TAX BASIS

To minimize your taxable gain, you will want to have the highest tax basis possible, and have the documentation to substantiate the basis calculation. So be sure to maintain accurate records, including information on your original cost (including closing costs) and subsequent capital improvements.

Basis must be reduced by any pre-1988 deferrals of gain (i.e., when the law allowed taxpayers to defer tax by buying a new principal residence costing more than the net proceeds of their principal residence).

LOSS ON THE SALE OF YOUR HOME

Based on historical evidence, you would expect your home to appreciate after you purchase it. However, if you only hold it for a short time, or if unusual market conditions prevail, it is possible to lose money on the sale of your principal residence, especially after factoring in closing and improvement costs. Since a loss on the sale of a personal residence is not deductible, you do not gain a tax benefit from the loss. But if part of your home was rented or was used for your business, the loss attributable to that portion will be deductible, subject to various limitations, since it is a business loss rather than a personal loss.

RENTAL OF VACATION OR SECOND HOME

You should consider the tax consequences if you are planning to rent out your vacation or second home. Proper planning can help you maximize tax savings.

Tax-free rental income

If you rent your vacation home or principal residence for 14 days or less during the year, the rental income is tax-free, regardless of the amount of rent you receive. Even though you do not have to report this income, you can still deduct the full amount of qualifying mortgage interest and real estate taxes as itemized deductions on your tax return.

Rental expenses deductible in full

If you personally use your vacation home (including family members) for no more than the greater of 14 days a year or 10% of the total number of days it is actually rented out, the property is considered to be a rental property rather than a personal residence. As rental property, all ordinary and necessary expenses of maintaining the home are deductible against the rental income you receive. However, if your expenses exceed your income, your deductible loss may be limited since the rental activity is considered to be a passive activity. See the chapter on passive and real estate activities for a more detailed discussion.

Rental expenses limited by personal use

If you personally use your vacation home for more than the greater of 14 days or 10% of the total number of days it is rented (or available for rental, under a Tax Court case), it is considered a personal residence and your deductions may be limited, as follows:

- Qualifying mortgage interest and real estate taxes are deductible as rental expenses based on the number of days rented divided by the total number of days in the year.

- The balance of the real estate taxes and mortgage interest are deductible as itemized deductions.

- Other rental expenses, including depreciation, utilities and repairs, are deductible based on a ratio of the days the property was rented over the total number of days the property was used for rental and personal purposes.

- Expenses directly attributable to the rental activity itself (such as broker commissions on the rental income or advertising costs) are deductible in full.

- Net overall losses from the rental of a personal use residence are not currently allowable but are carried forward and available for use against income from the property in future years, including a gain on the sale.

To the extent that the property qualifies as rental real estate (personal use less than 10% or 14 days) losses may be subject to the passive loss rules. See the chapter on passive and real estate activities for more information.

LIKE-KIND EXCHANGES FOR VACATION HOMES

See Tax Tip 17 in the passive and real estate activities chapter for information on a planning opportunity using like-kind exchanges for vacation homes.

REPORTING REQUIREMENTS

You would typically report the sale of your principal residence on Schedule D of your personal income tax return. However, you do not have to report the sale of your principal residence on your income tax return unless:

- You have a gain on the sale. You would typically show the entire gain on the Schedule D of your tax return and then reduce your gains by the excludible portion.

- You have a loss and you received Form 1099-S. Since the IRS matches all Forms 1099 to the return, you would want to show the sale proceeds on the return and that there is no gain on the sale. Remember personal losses are not deductible.