

IRS Issues Final Rules on Gain or Sale of Principal Residence

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After many long years of waiting, the Internal Revenue Service has issued final regulations regarding the tax treatment when a taxpayer sells the principal residence less than two years after it was purchased.

These new rules have significant impact, insofar as many homeowners have made fantastic profits in the past few years, but find that -- for many reasons -- they have to sell their house before they have owned it for a period of two years.

Why is this important? If you sell your house and have owned and used it for two years out of a period of five years before it is sold, you have the absolute right to exclude up to \$250,000 of the profit you have made from the sale. If you are married -- and file a joint tax return -- you can exclude up to \$500,000 of your profit.

However, if you have not owned and used your home for this two-year period, depending on the circumstances surrounding the sale, you may have to pay the full tax on your profit -- either at ordinary income rates or capital gains rates, depending on how long you have owned the property.

When Congress authorized these large exclusions back in 1997, it opened the door for reduced exclusions under certain limited circumstances. Section 121(c) of the Internal Revenue Code specifically provides that even if a taxpayer did not own and use the house for the full two-year period, if the house has to be sold for reasons of (1) a change in place of employment, (2) health or (3) unforeseen circumstances as provided and defined in IRS regulations, the taxpayer may nevertheless be entitled to a partial exclusion of the gain.

The new regulations are required by law, in order to spell out a definition of "unforeseen circumstances" and give guidance to both the taxpayer as well as the IRS. The regulations also provide what the IRS calls "safe harbors" -- i.e. if you fall into a safe harbor category, you are entitled to take the partial exclusion. If, on the other hand,

you are not within the safe harbor, then according to the regulations "the taxpayer may be eligible to claim a reduced maximum exclusion if the taxpayer establishes, based on the facts and circumstances, that the taxpayer's primary reason for the sale ... is a change in place of employment, health or unforeseen circumstances."

In other words, if you are not within a safe harbor, you will have to convince the IRS that you nevertheless qualify for the partial exemption. Safe harbors under the unforeseen section include, but are not limited to:

1. Change in employment: If you have to travel at least 50 miles farther from the house you sold because of a job transfer, or even to take a new job, and the primary purpose of selling your house was because of employment reasons, you will be eligible for the partial exclusion.

The 50-mile distance is the IRS "safe harbor," provided that the change in place of employment occurred during the time that the taxpayer owned and used the home. However, even if you cannot meet the safe harbor, you still may be able to convince the IRS to allow the partial exemption based on "facts and circumstances." The regulations include an example of a doctor who sold her condominium and moved only 46 miles away from the previous residence.

Because the primary reason for the sale was to allow the doctor quicker access to the hospital for emergency purposes, the IRS would allow the partial exemption based on the facts of this case.

2. Reasons of Health: Once again, we see the concept of "primary purpose." To qualify for the partial exemption, the primary purpose of selling the house must be based on health.

The safe harbor here is easy: If the taxpayer's physician recommends a change of residence for reasons of health, the taxpayer



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will automatically qualify for the partial exclusion. And health is rather broadly defined to include "the diagnosis, cure, mitigation or treatment of disease, illness or injury."

But the IRS issues a precautionary note: A sale "that is merely beneficial to the general health or well-being of an individual is not a sale ... by reason of health."

3. Unforeseen circumstances: Obviously, this is the more difficult category on which to enact regulations. Each of us -- at one point in time -- will face conditions which significantly impact on our lives -- and on our financial situation -- which could not be anticipated or even imagined before it happened.

Nevertheless, it would be manifestly unfair to be faced with a crisis -- have to sell your house before the two years are up -- and have to pay full tax on the profit you have made. Accordingly, Congress authorized the IRS to issue regulations governing this area.

According to the new regulations, a sale "is by reason of unforeseen circumstances if the primary reason for the sale ... is the occurrence of an event that the taxpayer could not reasonably have anticipated before purchasing and occupying the residence."

It is interesting to note that the IRS has given a broad definition to the concept of "qualified individuals." Such persons include the taxpayer, the spouse of the taxpayer, a co-owner of the residence and even a "person whose principal place of abode is in the same household as the taxpayer."

Why such a broad coverage? According to the IRS:

The inclusion in the safe harbors of events affecting co-owners and co-inhabitants is appropriate because these events may affect the taxpayer's ability to pay housing costs.

If you are eligible for the partial exclusion -- either because you meet the safe harbor tests or the facts and circumstances test -- this exclusion is equal to the number of days of use times the quotient of \$500,000 divided by 730 days. Note that 730 days is two full years. If you are single -- or do not file a joint tax return -- change the \$500,000 to \$250,000.

If real estate sales start slowing down, and profits start dropping, these new regulations may be completely academic. However, if you find that you have to sell your house before you have owned and used it for two full years, and if (as have many people) you will make a significant profit, it clearly is important to try to qualify for the partial exemption.

If you are in doubt, try to hang on to your house until you meet the two-year test. You may find that with a little effort, you can save a lot of tax dollars.

The IRS then lists several safe harbors:

- Involuntary conversion of the residence -- for example, its condemnation by a governmental agency;
- Natural or man-made disasters or acts of war or terrorism resulting in a casualty to the residence;
- Death of one of the owners of the property;
- The cessation of employment as a result of which the taxpayer is eligible for unemployment compensation;
- A change in employment or self-employment status that results in the taxpayer's inability to pay housing costs and reasonable basic living expenses;
- Divorce or legal separation under a court decree, or
- Multiple births resulting from the same pregnancy.

These are safe harbors. If you fall within one of these areas -- and have owned and used your house during the time since it was purchased -- you will be entitled to take the partial exclusion of gain.

But, once again, even if you cannot claim a safe harbor, you still may be able to convince the IRS that there are facts and circumstances which forced you to sell your house before the two years were up. The burden will be on you, and as we all know, dealing with the IRS is not easy.

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