# San Diego Market Focus

# Capital Gains: What If You Don't Own Your House For Two Years?

If you owned and lived in your home for two years, the law is clear: you can exclude from profit up to $250,000 if you are single or $500,000 if you are married and file a joint return. But what if you have made a profit on your house, but sell it before the magic two years spelled out in the tax law?

In 1997, when Congress enacted this favorable legislation, it had absolutely no inkling that the real estate market would be so hot, and that so many homeowners would make such large profits on their home sales - even if they did not own their property for the full two years. However, Congress did provide reduced exclusions if prior to holding the property for the full two years, the homeowner had to sell due to a change in employment, health reasons or "unforseen circumstances".

For over five years, taxpayers were in the dark as to what the IRS would consider as "unforeseen". Finally, effective December 24, 2002, the IRS issued temporary regulations, dealing with home sales within the two year period. According to the IRS, they have established certain "safe harbors". If the taxpayer falls within one of these safety zones, they will automatically be entitled to the appropriate exclusion of gain. Here are some of the new, but temporary, "safe harbors":

Employment: here, the temporary regulations are quite clear. If the new place of employment is at least 50 miles farther from the residence sold than was the former place of employment, the homeowner who sells his/her home in order to be closer to the job can take a proportionate exclusion of gain. For example, if the homeowner owned the home for only one year, that homeowner would be entitled to exclude half of either the $250,000 or the $500,000 exclusion, depending on the marital and tax filing status of the taxpayer. According to the regulations, employment is defined as "the commencement of employment with a new employer, the continuation of employment with the same employer, or the commencement or continuation of self-employment."

Health: if a doctor recommends a change of residence for reasons of health, this will be a safe harbor under the new temporary regulations. What determines "health"? According to the IRS, "if the taxpayer's primary reason for the sale is (l) to obtain, provide, or facilitate the diagnosis, cure, mitigation, or treatment of disease, illness, or injury... or (2) to obtain or provide medical or personal care for a qualified individual suffering from a disease, illness or injury." It should be noted that "qualified individuals" includes family members who are in need of medical assistance away from the principal residence. The IRS made it clear, however, that a sale of the family home merely because it is beneficial to the general health or well-being of the taxpayer will not fall within the safe harbor.

Unforseen circumstances: Congress passed the buck to the IRS to come up with definitions - safe harbors - under this amorphous category. The IRS rose to the challenge, by providing that the following events would be considered "safe harbors", on the condition that these events involve the taxpayer, his/her spouse, co-owner or a member of the taxpayer's household: death; being terminated from employment and thus eligible for unemployment compensation; a change in job status that results in the taxpayer being unable to pay the mortgage and reasonable basic living expenses for the taxpayer's household; divorce or legal separation; multiple births resulting from the same pregnancy; Involuntary conversion of the property - such as a condemnation by a governmental authority, and destruction of the property because of a man-made disaster, an act or war or terrorism.

Additionally, the IRS kept the safe harbor door open by allowing the IRS Commissioner the right to expand these seven items should the need arise –either generally or in response to a particular situation involving a specific taxpayer.

These regulations can be applied retroactively. Even if you sold your home after May 7, 1997 and have already filed a tax return for the year in which the sale took place, you have the right to file an amended tax return (using IRS Form 1040X). The temporary regulations provide that the IRS "will not challenge a taxpayer's position that a sale before the effective date of the regulation's (December 24, 2003) but on or after May 7, 1997, qualifies for the reduced maximum exclusion... if the taxpayer has made a reasonable, good faith effort to comply with the requirements of (the law) and if the sale... otherwise qualifies under (the tax law)." Taxpayers who believe that they are entitled to claim an exemption because they fall into one of these safe harbors should immediately consult their tax advisors.

*Written by Benny L. Kass*
*Reprinted with permission of Realty Times www.realtytimes.com*

Chicago Title

*"The Best Coverage, the Best Company"*