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Make the Most out of Selling your Home

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Many people may not realize it but selling your home is actually a taxable event. However, due to certain tax rules in place, it rarely affects your 1040 since losses are nondeductible and gains are generally excluded to the extent of $250,000 if you're single and $500,000 if married filing jointly, providing you meet the ownership and occupancy tests, below. While the past several years have been unkind to homeowners looking to sell their homes and at least manage to break even, the housing market is finally starting to improve. With the housing market rebounding, the question, "How can I save the most in taxes when I sell my home," is becoming relevant again.

When looking to sell your home, be sure to keep records of what you paid to acquire and improve your home and how much you're hoping to get for it. If the difference exceeds the home-sale gain exclusion amounts of $250,000 or $500,000 mentioned above, you may want to consider some other options to bring the taxable gain down even more. One intriguing option is to convert it to rental use for a couple years, which would allow you to generate some rental income while planning to meet the non-recognition rules under section 1031. The non-recognition rules under section 1031 state that when you exchange like kind properties, you maintain the basis you had in the original property. While this does not exclude gain from your tax return it does defer the gain into the future.

One of the major benefits of converting you home into a rental property and applying the non-recognition rules is that you get to add the home-sale exclusion amount used to your basis. In the example below, the taxpayer's exchanged their home, after converting it to a rental, for a new home with a fair market value of $750,000. Their cost basis in their old home was $200,000, resulting in a $550,000 gain. Since they are married and met the ownership and occupancy tests under section 121, below, they receive a $500,000 exclusion, bringing their reportable gain to $50,000. Then, once they apply the non-recognition rules of section 121, their current year taxable gain is reduced to $0. Note that, since their reportable gain is $0 their basis in the new home is reduced by the amount of the deferred gain.

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$ 750,000	Fair Market Value of House received
$ 200,000	Cost Basis in Current house
$ 550,000	Gain
$ 500,000	Section 121
$ 50,000	Adjusted Gain
$ 50,000	Section 1031
$ -	Taxable Gain

$ 750,000	FMV of New Property
$ 50,000	Deferred Gain under §1031
$ 700,000	Adjusted basis in new rental

A couple important notes to keep in mind when considering this strategy:

1. To be considered a principal residence for the home-sale gain exclusion you must have owned and resided in it for at least 2 out of the previous 5 years.
2. The property must have been used in a trade or business or held for investment for at least two years leading up to the sale.
3. Any cash received in the transaction could be taxable if it exceeds the home-sale gain exclusion
4. When applying both the home-sale gain and non-recognition rules to the sale of a property, the home-sale gain exclusion is applied first.
5. When engaging in a tax deferred exchange under section 1031, it is critically important that all the rules are followed to the letter.

For questions on this or any other tax topics, please contact one of the tax professionals at Zinner & Co.

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