Certified Public Accountants and Management Consultants

Financing the Sale of Your Home

Robert O'Neil, CPA

Financing the sale of your home can be a great way to sell your home and make a little extra money in the transaction. The basics of a seller-financed sale are that you sell your home, issue a loan to the buyer, and collect interest and principal each year until the buyer pays off the loan. In addition to receiving interest income on the loan, any gain on the sale is excluded up to the section 121 gain on the sale of a personal residence limits. These limits are $250,000 for a single taxpayer or $500,000 for a married filing joint taxpayer. This leaves one major question: What happens if the buyer defaults?

On the surface, this question seems simple; you repossess the home, write off any remaining mortgage, and relist. However, upon repossession, there could be recognition of gain based on the principal payments received multiplied by the ratio of total gain over total sales price. Fortunately, the gain would only be recognized if it exceeded any gain previously recognized. It is also important to note that when you resell the home there can be a major tax impact.

Under the rules of section 1038(e), if you sell your residence prior to one year following repossession, you can treat both of the sales as one transaction. The formula to determine the gain would be:

Proceeds from second sale
<u>Plus: Principal payments received from first sale</u>
Equals Total Sales Price
Less: Original Cost basis
Less: Cost of first sale
Less: Cost of repossession
<u>Less: Cost of second sale</u>
Equals: Total Gain/Loss

Any gain, up to the amount of the section 121 exclusion, would be excluded from reportable income and the transaction would be complete.

Now what happens if the property is not sold within the one year period? Then all three transactions (initial sale, repossession, and second sale) are reported separately. On the initial sale of the property you would use the section 121 exclusion and pay tax only on any gain in excess of the above exclusion amounts. Upon repossession, there may be a taxable gain based on the ratio of total gain over the total sale price multiplied by any principal payments received. Finally, upon the second sale, the adjusted basis of the property would be the unpaid balance on the mortgage plus any repossession costs. When the second sale occurs, any gain would be taxable since the section 121 exclusion would already have been used in the initial sale.

For answers to these and other tax questions, contact one of the tax professionals at Zinner & co. LLP.

3201 Enterprise Parkway, Suite 410 • Beachwood, OH 44122
P: 216.831.0733 • F: 216.765.7118 • zinnerco.com