By Andrew L. Gradman

Code § 121:

How to Save Taxes When You Sell Your Home

WHEN YOU SELL YOUR home, some of the profit may be tax-free. In this column, I'll describe some of the surprising pitfalls and powerups behind this exception, which appears at Internal Revenue Code §121.

First, the general rule: When you sell property, you're taxed on the gain. Gain equals proceeds minus basis. Basis generally equals cost, including cost of improvements. So the easiest way to save tax is the most commonly shunned: keep your receipts.

When the property sold is a home which you owned for at least a year, the gain is taxed at the federal long-term capital gains rate (20%), just like when you sell Disney stock. You also owe the 3.8% Net Investment Income Tax, plus state tax.

Some taxpayers remember when you could just roll the proceeds from one home tax-free into another home of lesser value. This was repealed in 1997. Today, under §121, you can exclude up to $250K of gain ($500K if married), as long as you owned the property for two of the five years before the sale, and used it as your principal residence for two of the five years before the sale. Here's the fine print:

Cures for less than 2 years. Your failure to meet both two-year tests can be cured in various ways.

- If, for the year of the sale, you were married filing jointly, both spouses will meet both tests if either did. §121(d)(1).
- If, on the date of the sale, you were a widow, you can count the decedent's use and ownership. §121(d)(2).
- If you acquired the property "incident to divorce," you can count ownership (but not use) by the transferor. §121(d)(3)(A).
- If you own the property but your spouse is using it under a divorce or separation instrument, you are treated as using the property. §121(d)(3)(B).
- If you meet the use test for one year, and become physically or mentally incapable of self-care, you can satisfy the second year of use while you own it and reside in a licensed health care facility, such as a nursing home. §121(d)(7).
- Benefits will be prorated, if your primary reason for selling early was new employment more than 50 miles away, a genuine medical need, or an event you could not reasonably have anticipated before buying and occupying the residence. §121(c). The examples given for this last category include multiple births resulting from the same pregnancy, or damage to the residence caused by terrorists. Thankfully, your excuse doesn't have to be on the list; you just have to show it was unforeseen, not reasonably foreseeable, and was really your "primary reason" for selling or moving.

Beware of entity owner. You can't get the benefits of §121 if you own the residence through an entity that files a tax return (e.g.: a corporation; an LLC taxed as a partnership; a nongrantor trust). But it's fine if you own through a disregarded entity (e.g.: an LLC wholly owned by you; a grantor trust settled by you). Treas. Reg. §1.121-1(c)(3).

Two (or more) residences. Only one home can be your principal residence. If you have two homes, time used is "ordinarily" the decisive factor. But other factors remain "relevant," including where you work and where your family lives. Treas. Reg. §1.121-1(b)(2). Since the term "principal residence" is never defined, I suppose the winning mix of factors depends on how much the IRS auditor values work and family, and whether she likes your dictionary.

Business use of home. If your tax return reflects that you're using part of your home for business, e.g. as a home office or rental property, then think of the sale of your home as being

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a sale of two assets: a residence, and a business property. Gain attributable to the latter—including gain attributable to depreciation recapture—cannot enjoy the benefits of §121. Example: if a couple sells their house for $510K of gain, of which $20K is from depreciation of a home office, they can only exclude $490k. §121(d)(6). Under a separate rule, if you convert your home into a rental, you'll be penalized for later moving back in; you'll lose a fraction of the exclusion equal to the fraction of the five years used as a rental. Strangely, this wouldn't apply if you'd sold the property as a rental. §121(b)(5).

Sales of partial interests. If you own less than 100% of a house, you still get your full exclusion as to your partial interest. See §1.121-2(a)(2) and (a)(4), Example 1. I have always found this strange. It suggests a loophole which deserves to be further explored. Pause and see if you can figure it out. While you do, be sure to meditate on the fact that nothing herein constitutes legal advice by myself or the editors of *Valley Lawyer*.

Ready? Consider this hypo: Two years before selling their residence, Husband and Wife deed 25% interests to their two children. Later, they all sell. H+W claim a $500k exclusion on the gain from 50% of the house, while each child claims a $250k exclusion on the gain from 25% of the house. Result: By looping in the kids, H+W purport to have doubled the available exclusion, from $500k to $1M.

This description assumes away some important challenges. Can the kids be trusted to cooperate? Can they be trusted with the money? Do they need a guardian ad litem? Can a trust help? The role of the tax planner is to solve these challenges in a way that doesn't change the substance of the transaction so much as to change the tax treatment. The solution will differ from family to family.

But all these scenarios have one question in common: Is it ever possible to add an extra $250k exclusion by deeding part of your home to your child? I see nothing in the code or the regulations which rules this out, and I am aware of no IRS guidance or caselaw which addresses it. As for whether the IRS or the courts will forbid it in the future—for that, consult with your tax professional.

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