M E M O R A N D U M

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"Sale of principal residence strategies have to adapt"

Tax Strategy by George G. Jones and Mark A. Luscombe TAX PRACTICE – May 15-June 4, 2006

Almost nine full years have passed since the $250,000/$500,000 exclusion of gain on the sale of a principal residence first became available. Little did many of us imagine how much would change in nine years.

While the basic sale-of-a-principal-residence provision has remained the same, except for some minor congressional tinkering, the world in which it lives has not. The real estate "boom," capital gains rate reduction, subsequent ruling and other developments have all played a part in making this a particularly dynamic area of tax planning. A review of recent tends and developments over the past year is especially illuminating.

Real estate boom

When the Taxpayer Relief Act of 1997 first allowed for the $250,000/$500,000 exclusion, most people thought virtually any residential sale would be tax free. Inflation and the real estate boom, however, put an end to those dreams, as more and more home sellers see taxable capital gains on some portion of their sales price. Now, unless there is a significant decline in real estate prices, many more homeowners who intend to stay in their residences for some time should expect to pay a portion of their eventual profits as capital gain.

One piece of proposed legislation would index the home-sale exclusion for inflation each year. Another would double the exclusion for homeowners age 50. Still another would allow a surviving spouse to claim the married couple exclusion for up to one year after the death of the other spouse, rather than only within the same tax year. None of these proposals have yet to gather a groundswell of support.

Recognizing capital gain income on the sale of a residence also subjects a greater number of taxpayers to reduced itemized deductions and personal exemptions because of adjusted gross income limitations. It also can more easily subject those taxpayers to alternative minimum tax liability.

Also looming as a wild card is the rate of tax that eventually will be imposed on the taxable portion of gain. While capital gains currently are taxed at a maximum of 15 percent, that rate sunsets at the end of 2008, unless it is extended by Congress, For homeowners not planning to sell until 2010 or later, the capital gains tax rate is anyone's guess.

Basis

One way to reduce taxable capital gain is to increase the homeowner's tax basis in the residence. A recent Tax Court case shows that not knowing the rules on claiming basis increases can mean not only paying more capital gain, but also paying penalties. It also shows that homeowners who, several years ago, did not keep receipts for improvements because the $500,000 exclusion seemed so high, now won't be given too much slack in reconstructing records.

The married taxpayers in this recent case understated gains from the sale of their residence due to an overstated cost basis, and were liable for the negligence penalty. Although they claimed increases to the residence due to an overstated cost basis, for improvements, most of the increases were not sufficiently substantiated. A small increase to basis for swimming pool improvement costs reflected in the taxpayers' contemporaneous records was allowed. The evidence relating to the swimming pool was credible; however, other unsubstantiated costs based on memory were not allowed.

Energy credits

Starting in 2006 and continuing through 2007, the Energy Policy Act of 2005 provides a credit for individuals who make energy-efficiency improvements to their homes. Unfortunately, the taxpayer's basis in the property, including the cost of the qualified energy-efficiency improvements, must be reduced by the amount of the home improvement energy credit.

Individuals may claim a maximum $500 credit of 10 percent of the cost of purchasing insulation systems that reduce heat gain or loss, exterior windows (including skylights), exterior doors and metal roofs that meet Energy Star requirements.

In addition, the credit us available for costs of certain residential energy property: $50 credit for each advanced main air circulating fan; $150 credit for each qualified natural gas, propane or oil free furnace or hot water heater; and $300 credit for each item of qualified energy-efficient property. Further, a 30 percent annual credit is available for the addition of qualified solar panels (maximum $2,000) or a qualified fuel cell power plant (maximum $500 for each half kilowatt of capacity).

In each case, the cost of the qualifying improvement increases the basis that the homeowner has in the home, but only after the credit amount is deducted. In virtually every case, however, foregoing a tax credit for a similar amount of capital gain taxed at a 15 percent rate would not make sense.

Sales tax building materials

Like the energy credits, claiming the itemized federal state and local sales tax deduction may also impact basis of a personal residence. For 2005 (and in later years, if extended by Congress) taxpayers can calculate their deduction either by saving receipts or using the Optional State Sales Tax Tables provided by the Internal Revenue Service.

Any sales taxed paid on the home building materials may be taken in addition to an amount determined under the Optional State Sales Tax Tables. If materials used to increase the basis of a residence carried a sales tax that was deducted, the homeowner should deduct that sales tax amount from basis.

Home office

Some homeowners are getting a surprise in the form of home office depreciation recapture when they sell their residence. The benefit of using the personal residence exclusion on gain is not available to the portion of the gain not in excess of depreciation previously taken under the office-at-home deduction. In addition to being taxed, that recaptured gain is taxed, at a 25 percent rate, rather than the 15 percent capital gains rate. This recapture applies to all depreciation, not just the accelerated portion.

Despite recapture, however, the homeowner generally remains better off taking the depreciation deduction for a legitimate office at home. First, the depreciation is taken on Schedule C, and therefore also lowers Social Security taxes. Next, it offsets ordinary income that may be taxed at greater than a 25 percent rate. Finally, it plays on the time value of money by offsetting current income at the expense of a future payment.

There are two caveats to office-at-home depreciation recapture. First, if other home office expenses are put on Schedule C (as opposed to taking Schedule A deductions), there is the danger that the IRS will require recapture even if depreciation was not taken. The IRS has announced that it will follow the rule that depreciation reduces basis whether or not it is claimed. Presumably, however, it would have the burden of proving exclusive business use of the space in these situations, which might be difficult.

Second, if the office at home is in a structure separate from the taxpayer's main house, not only will depreciation recapture be required, but also percentage of the gain on the entire sale based on the value of the home-office structure will be subject to capital gains tax, without the benefit of the homesale exclusion.

Dual Use

Business-related deductions are not allowed for dual use of a portion of a residence for both personal and business purposes. While dual use can scuttle current deduction, it can help preserve a personal residence gain exclusion for a larger portion of the property.

The Tax Court recently decided that the owner of a bed-and-breakfast could not deduct expenses related to the portion of the inn that was used for both personal and business purposes (for example, a room occasionally used as a lounge for guests in which the owner also sat and paid bills). The court found that the disallowance and exclusive-use rules barred the deduction. The court al rejected the owner's argument that use of the area was so commercial and different from a personal residence that the disallowance/exclusive-use rules should not apply. It also rejected the application of a de minimis use exception.

Unforeseen circumstances

Subject to exceptions, the $250,000/$500,000 personal residence exclusion is considered an all-or-nothing benefit that can be used only once every tow years. The taxpayers must have owned and used the property as their principal residence for periods totaling two out of five years before the sale.

A reduced pro-rate exclusion, however, is available when a taxpayer sells because of unforeseen circumstances, a change in employment or for health reasons. Generally, an unforeseen sale or exchange must be due to the occurrence of an event that the taxpayer could not have reasonably anticipated before purchasing and occupying the residence.

Recent letter ruling indicate that the IRS will allow a good deal of flexibility under this exception:

- ❖ Moving to a larger home to make room for an adopted child;
- ❖ Moving out of a neighborhood after the homeowners were assaulted by their neighbors and their son was threatened and assaulted;
- ❖ Selling a small home being rented out but to which the taxpayer intended to return, after marrying a spouse with many children;
- ❖ Moving out of a community with an age restriction after a daughter divorced and wished to "move back home" with her children; and,
- ❖ Moving to an assisted living facility, followed by a move to a hospice by one of the homeowners.

Relocation services

Rev. Rul. 2005-74 explains when a sale of a home by an employee to her employer for subsequent sale to third parties through a relocation management company would be considered as one or two sales of the property. The ruling addresses two issues:

- ❖ Should the employer or employee report interim capital gains or losses before a sale to the next homeowner?
- ❖ Are payments of carrying charges before the final sale to the next homeowner considered compensation income?

If the RMC agrees to purchase employee homes at fair market value and then sells them to third-party buyers, tow sales occur, even where the employee gives the RMC a "blank deed" on which it has the option of putting itself or the ultimate third-party purchases as titleholder. Any subsequent loss or selling expenses won't be considered compensation.

If the RMS agrees to buy the home upon an "amended value option" based on matching a bona fide offer from a third party, tow sale are also deemed to occur.

If the employee maintains contralto of the counter-offer process and proceeds are distributed only when the sale to the third-party buyer closes, however, the IRS maintains that there is only one sale for federal tax purposes.

Like-kind exchanges

No survey of recent developments on the homesale exclusion can be complete without mention of Rev. Proc, 2005-14. Although issued in the early 2005, its impact continues to be discovered by a legion of grateful homeowners.

The American Jobs Creation Act of 2004 amended Code Sec. 121 to deny the exclusion to business property that is acquired in a like-kind exchange, converted to a personal residence, and disposed of within five years after the like-kind exchange. Congress was concerned that the homeowner exclusion could be used to shelter the gain realized on the like-kind exchange, if the residence was sold shortly after the like-kind exchange occurred. Patience is still rewarded with respect to those who wait long enough (five years instead of two) after the exchange to sell their residences.

Rev. Proc. 2005-14 involved two scenarios, each involving principal residences. In the first instance, the principal residence was used as a residence for at least two years and then as a business. The second instance involved a home-office type situation. In both, the taxpayers could use both Code Sections 121 and 1031 to eliminate boot and reduce the amount of gain realized.

Under Rev. Proc. 2005-14 the Code Sec. 121 gain exclusion is applied before application of the Sec. 1031 nonrecognition rules. Cash or property that is not like-kind property is taken into account only to the extent that the amount exceeds gain excluded under Sec. 121 with respect to relinquished business property. The basis of replacement business property is increased by any gain on relinquished business property excluded under Se. 121.

Conclusion

Especially for individuals in “hot” real estate markets, avoiding taxable capital gains on the sale of a principal residence had become a major concern.

Currently, those who move often seem to be rewarded the most because of a renewable $500,000/$250,000 exclusion every two years. Moving simply to save taxes, however, remains low on most people’s list of priorities, especially with broker and mortgage fees, moving costs and emotional attachments put into the equation.

Some action, however, does seem to make sense. Like-kind exchanges in connection with business or investment property remain in a viable loophole for those able to use them. Keeping careful records for tax-basis purposes is another way to minimize any tax due.

In the end, however, the most appreciated advice to homeowners may be simply warning them in advance that a tax liability will be owed, especially so that they do not overextend themselves at the other end of their move.