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Tax on home sales

The boom in housing prices last year was welcomed by sellers, but there could be tax consequences. The tax blow for the sale of a principal residence may be softened, even eliminated, by the $250,000 exclusion from income ($500,000 for marrieds filing jointly) for the gain from the sale of a principal residence. These boundaries were set in 1997 and never adjusted for inflation. With the higher prices for some homes in 2021, the exclusion may not fully protect the capital gain from tax.

Long-term owners
To be eligible for the full exclusion for a home sale, one must have owned and used the property as a personal residence for at least two of the preceding five years. Short absences (such as vacations) are not a problem, but a prolonged absence could be.

The doubled exclusion of $500,000 for married couples is available if: (1) either spouse meets the two-year own¬ership test; (2) both spouses meet the two-year use test, and (3) neither spouse has claimed the exclusion within the prior two years. If one spouse is ineligible, the other may still claim up to $250,000.

Relief for short-term owners
If the two-year test can't be met, a partial exclusion may be salvaged if the home sale came about due to a change in the place of employment, a change in health or for "unforeseen circumstances." The IRS has provided exam¬ples that meet these vague requirements. For example, the exclusion would be available for a sale due to:
• multiple births from a single pregnancy;
• a lost job;
• a change in circumstances that leads to an inability to meet mortgage payments;
• development of a disease, illness or injury (selling to improve one's general health would not qualify).
For some taxpayers, a partial exclusion will be as good as a full one if it covers the full amount of their gain.

Good records are essential
These rules makes good recordkeeping more important than ever. Good records for current home owners will also be important when:
• the owners intend to stay in the home for a long period of time;
• they have invested heavily in renovations;
• there is a possibility that the owners will claim a depreciation deduction for a home office or rental use of the residence. Gain will have to be recognized to the extent of any depreciation deduction claimed.

The tax on the sale of a home applies to the net after the tax basis is subtracted from the sales proceeds. Basis includes what the taxpayer paid for the house plus major remodeling, such as a kitchen upgrade or a new roof. Routine repairs don't count. Details on allowable expenses are provided in IRS Publication 523.

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