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## IRS ISSUES HOME SALE EXCLUSION RULES

WASHINGTON – The Internal Revenue Service today issued guidance in the form of both final and temporary regulations related to excluding gain on the sale of a principal residence. A 1997 law substituted an exclusion of up to $250,000 ($500,000 for a married couple filing jointly) for the old "replacement residence" rules. Unlike a previous once-in-a-lifetime exclusion for senior citizens, the new exclusion may be claimed repeatedly, but usually only once every two years.

The final regulations cover such topics as:

- how to determine if a home is a principal residence;
- when gain from the sale of vacant land that was used as part of the residence may be excluded;
- when and how to allocate the gain between residential and business use of the property;
- how the exclusion applies to joint owners who are not married; and
- how to fulfill the requirement that the taxpayer own and use the home as a principal residence for two of the five years before the sale.

For taxpayers with multiple homes, the regulations list several factors relevant to determining which home is the principal residence. Among these are amount of time used; place of employment; where other family members live; the address used for tax returns, driver's license, car and voter registration, bills and correspondence; and the location of the taxpayer's banks, religious organizations or recreational clubs.

The home sale exclusion may include gain from the sale of vacant land that has been used as part of the residence, if the land sale occurs within two years before or after the sale of the residence.

Taxpayers need not allocate gain between business and residential use if the business use occurred within the same dwelling unit as the residential use. They must pay tax on the gain equal to the total depreciation they took after May 5, 1997, but may exclude any additional gain on the residence, up to the maximum amount. If the business use property was separate from the dwelling unit, they would allocate the gain and be able to exclude only the gain on the residential unit.

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For joint owners who are not married, up to $250,000 of gain is tax-free for each qualifying owner.

To exclude gain, a taxpayer must both own and use the home as a principal residence for two of the five years before the sale. The ownership and use periods need not be concurrent. The two years may consist of 24 full months or 730 days. Short absences, such as for a summer vacation, count as periods of use, but longer breaks, such as a one-year sabbatical, do not. The taxpayer also must not have excluded gain on another home sold during the two years before the current sale.

The IRS made these final regulations available for public comment in October 2000. Several changes resulted from the comments received, including the treatment of gain on property used for both business and residential purposes.

Today, the IRS invited comments on new temporary regulations on the subject of excluding gain, but with a reduced maximum amount, when the seller does not satisfy one of the time rules. The tax law provides an exception to the two-year rules for use, ownership and claimed exclusion when the primary reason for the sale is health, change in place of employment, or, to the extent provided in IRS regulations, "unforeseen circumstances."

Taxpayers may establish by the facts and circumstances of their situations that their home sales were for one of these reasons. To make things easier, the IRS has identified various "safe harbors" that will automatically establish that the sale is for one of these reasons.

The temporary regulations provide that a home sale will be considered related to a change in employment if a qualified person's new place of work is at least 50 miles farther from the old home than the old workplace was from that home. This is the same distance rule that applies for the moving expense deduction. The employment change must occur during the taxpayer's ownership and use of the home as a residence. A qualified person is the taxpayer, the taxpayer's spouse, a co-owner of the home, or a member of the taxpayer's household.

A sale will be considered because of health if the primary reason is related to a disease, illness, or injury of a qualified person. If a physician recommends a change in residence for health reasons, that will suffice. In addition to the persons listed above, a qualified person for health reasons includes certain close relatives, so that sales related to caring for sick family members will qualify.

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A sale will be considered as occurring primarily because of "unforeseen circumstances" if any of these events occur during the taxpayer's period of use and ownership of the residence:

- death,
- divorce or legal separation,
- becoming eligible for unemployment compensation,
- a change in employment that leaves the taxpayer unable to pay the mortgage or reasonable basic living expenses,
- multiple births resulting from the same pregnancy,
- damage to the residence resulting from a natural or man-made disaster, or an act of war or terrorism, and
- condemnation, seizure or other involuntary conversion of the property.

Any of the first five situations listed must involve the taxpayer, spouse, co-owner, or a member of the taxpayer's household to qualify. The regulations also give the IRS Commissioner the discretion to determine other circumstances as unforeseen.

For qualifying sellers, the maximum exclusion amount of $250,000 ($500,000 for a married couple filing jointly) is limited to the percentage of the two years that the person fulfilled the requirements. Thus, a qualifying seller who owns and occupies a home for one year (half of two years) – and who has not excluded gain on another home in that time – may exclude half the regular maximum amount, or up to $125,000 of gain ($250,000 for most joint returns). The proportion may be figured in days or months.

A taxpayer who now qualifies for a reduced maximum exclusion and has already reported a gain from the sale of a residence on a prior year's tax return may use Form 1040X to file an amended return claiming the exclusion. Taxpayers may generally amend returns until three years from the original due date. The law did not require taxpayers to meet one of the exceptions before using the reduced maximum exclusion for homes owned on August 5, 1997, and sold within two years after that date. Thus, nearly all taxpayers qualifying under these regulations should be able to use them by amending a recent year's return.

Treasury Decision 9030, the final home sale regulations, and T.D. 9031, the temporary and proposed regulations on the reduced maximum exclusion, will be published in the *Federal Register* on December 24, 2002, and will be available at *www.federalregister.gov*. These regulations will also be published in Internal Revenue Bulletin. The proposed regulations will also be available for comment soon on the IRS Web site at *www.irs.gov*.

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