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FACT SHEET

SELLING YOUR HOME? SOME IMPORTANT TAX CONSIDERATIONS

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Changes in family size or employment location and other circumstances frequently make it desirable or necessary for a family to sell its residence. If the family has owned a home for a reasonably long time, there probably has been a sizable increase in the value of that home. Provisions of the Economic Recovery Tax Act of 1981 could substantially reduce a family's tax liability on the gain realized from the sale. Two provisions pertain to the sale of a taxpayer's principal residence after July 20, 1981.

For homeowners 55 and older

The first provision pertains to taxpayers who are 55 or older at the time of the sale (only one spouse needs to be 55). Qualifying taxpayers can elect to exclude from gross taxable income up to $125,000 of any gain realized from the sale of a principal residence ($62,500 for married individuals filing separate returns). However, this election can be exercised only once in a lifetime and is binding on both spouses. Additionally, the taxpayer must have owned and occupied the property as a principal residence for 3 or more years during the 5-year period before the sale.

Since the exclusion may be elected only once, this provision has important implications for married taxpayers who elect it during a marriage which may later be dissolved by divorce or by the death of a spouse. Remarriage will not reinstate the election.

For homeowners of any age

A second provision in the act applies to homeowners of any age. It requires taxpayers to defer taxes on a gain realized from the sale of a principal residence if a replacement residence that costs at least as much as the sale price of the residence sold is purchased or built within 24 months of the sale. Normally, only one tax-deferred sale is allowed during each 24-month period; an exception in the act permits more than one such transaction (usually called a *rollover*) within 24 months if the taxpayer relocates for employment purposes. The same standards currently in effect concerning deductibility of moving expenses are used to determine if the sale was caused by a change of employment location.

The act permits taxpayers who are 55 or older to use both provisions to minimize taxes on the sale of their home. For example, suppose a 55 or older taxpayer realizes a $200,000 gain on the sale of a principal residence for $400,000. If that taxpayer purchases or builds a replacement for $275,000 within 24 months, taxes on the entire gain are minimized. This homeowner could postpone $75,000 through the rollover provision and exclude $125,000 by the election available to older taxpayers. This permits those 55 or over to "step down" in the housing market and minimize their tax burden.

Line No.		Amount
1 and 2	These lines ask for the dates of the sale and replacement. They are not included in the calculations.	
3	Selling price of the residence.	$182,000
4	Commissions and other expenses of sale not deducted as moving expenses.	10,000
5	Amount realized (subtract line 4 from line 3).	172,000
6	Basis of residence sold.	30,000
7	Gain on sale (subtract line 6 from line 5). (If line 6 is more than line 5, enter zero and do not complete the rest of form.)	142,000
8	Fixing-up expenses.	2,000
9	Adjusted sales price (subtract line 8 from line 5).	170,000

Table 1. Computation of Gain on the Sale and Adjusted Sales Price

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Line No.		Amount		
		Case A	Case B	Case C
10	Cost of new residence.	$175,000	$ 75,000	$ 25,000
11	Gain taxable this year. (Subtract line 10 from line 9. Do not enter more than line 7. If line 10 is more than line 9, enter zero.)	-0-	95,000	142,000
12	Gain to be postponed. (Subtract line 11 from line 7.)	142,000	47,000	-0-
13	Adjusted basis of new residence. (Subtract line 12 from line 10.)	33,000	28,000	25,000

Table 2. Computation of Taxable Gain on the Sale: Adjusted Basis of New Residence without $125,000 Exclusion

IRS Form 2119

The Internal Revenue Service has provided *Form 2119*, entitled "Sale or Exchange of Principal Residence," to help taxpayers calculate: (1) the gain on the sale of the old residence, (2) the adjusted sales price of the old residence, (3) the amount of taxable gain and (4) the adjusted basis of the replacement residence (if any).

Tables 1, 2 and 3 show the calculations related to a hypothetical sale of a residence and replacement.

When combined, these three tables are, for the most part, a duplication of IRS *Form 2119* used by taxpayers who sold a residence in 1982.

Table 1 shows the information required to complete the first nine lines of IRS *Form 2119* (lines 3, 4, 6 and 8 are sample figures).

As shown, Table 1 includes the calculation of the gain on the sale of the residence and the adjusted sales price of the residence (lines 7 and 9 respectively). These figures are used for the completion of Table 2, Table 3 or both.

Table 2 includes lines 10 through 13 of IRS *Form 2119*. This is the portion of the form that all taxpayers under 55 and those 55 or over *who do not elect* the $125,000 exclusion use to calculate the amount of the gain on a sale that is taxable and the adjusted basis of a replacement residence purchased or built within the 24-month time limit. To illustrate the effect of various priced replacements on taxable income, three cases are included in Table 2 (IRS *Form 2119* includes only the actual transaction and thus has only one column). Line 10 shows the assumed cost of the new residence to be $175,000, $75,000 and $25,000 in Cases A, B and C respectively.

Note that in Case C the amount identified as gain taxable this year (line 11) is limited to the total gain on the sale (line 7) rather than the $145,000 difference between the adjusted sales price of the old residence and the cost of the new residence.

The final seven lines of IRS *Form 2119* are shown in Table 3. This is the portion of the form that taxpayers who are 55 and older use to elect the $125,000 exclusion and to calculate their taxable gain and adjusted basis of their new residence. The same three cases from Table 2 are again considered in Table 3, but the $125,000 exclusion is included in the computations to illustrate its impact. (Line 17 shows the assumed costs of the three alternative replacements to be the same as line 10 in Table 2.)

Table 4 summarizes the effects of electing the $125,000 exclusion on taxpayers in the three assumed cases. Two important comparisons are included in the

Line No.		Amount		
		Case A	Case B	Case C
14	This line determines the qualifications of the taxpayer to elect the exclusion. It is not included in the computations.			
15	For sales after July 20, 1981 enter the smaller of line 7 or $125,000 ($62,500, if married filing separate returns).	$125,000	$125,000	$125,000
16	Part of gain included (subtract line 15 from line 7).	17,000	17,000	17,000
17	Cost of new residence.	175,000	75,000	25,000
18	Gain taxable this year. (Subtract the sum of lines 15 and 17 from line 9. The result cannot be more than line 16.) If line 17 plus line 15 is more than line 9, enter zero.	-0-	-0-	17,000
19	Gain to be postponed (subtract line 18 from line 16).	17,000	17,000	-0-
20	Adjusted basis of new residence (subtract line 19 from line 17).	158,000	58,000	25,000

Table 3. Computation of Exclusion, Taxable Gain and the Adjusted Basis of the New Residence.

	Case A	Case B	Case C
I. Disposition of gain without $125,000 exclusion.			
a. Taxed (line 11).	$ -0-	$ 95,000	$ 142,000
b. Postponed (changes the basis of new residence); (line 12).	142,000	47,000	-0-
Total gain (line 7).	$ 142,000	$ 142,000	$ 142,000
II. Disposition of gain with $125,000 exclusion.			
a. Taxed (line 18).	$ -0-	$ -0-	$ 17,000
b. Excluded (line 15).	125,000	125,000	125,000
c. Postponed (changes the basis of new residence); (line 19).	17,000	17,000	-0-
Total gain (line 7).	$ 142,000	$ 142,000	$ 142,000
III. Adjusted basis of new residence.			
a. Without exclusion (line 13).	$ 33,000	$ 28,000	$ 25,000
b. With exclusion (line 20).	$ 158,000	$ 58,000	$ 25,000

Table 4. Summary.

table: (1) the taxable incomes in cases B and C are reduced substantially and (2) the adjusted basis (and consequent tax liability from a future sale) of the new residences in cases A and B are affected.

The major points derived from Table 4 are:

1. Even if the $125,000 exclusion is not necessary to reduce the taxable income (case A) of a seller who is 55 or older, it can increase the adjusted basis of a replacement residence. Because the exclusion is binding on both spouses this is a crucial point for a taxpayer who is considering the exclusion and may later marry someone who previously used the exclusion. If the decision is made to elect the exclusion, future tax relief will occur if the replacement residence is sold (because of the higher basis); if the exclusion is not used before the marriage it will not be allowed during a subsequent transaction.
2. Case B illustrates an example where the $125,000 is used to reduce a $95,000 taxable gain to zero while retaining the unused $30,000 of the exclusion for possible future tax relief. This can happen because the adjusted basis of a replacement principal residence will be increased by $30,000; the basis will reduce taxable gains, if forthcoming, from future transactions.
3. The comparisons in case C are most applicable to a retired taxpayer who decides to dramatically "step down" in housing (from a $182,000 home to a $25,000 home). This case illustrates a substantial decrease in current taxable income. It follows the intent of the legislation to allow older taxpayers to liquidate their home equity and use the gains to help meet their retirement needs.
4. A general observation from an examination of the examples is that taxpayers 55 or older who sell their principal residence and receive gains of $125,000 or more probably should take the exclusion (unless there is good reason to think that the amount will substantially increase via future legislation). All of the previous examples assume that the gain was in excess of $125,000. If the gain is less, line 15 of IRS *Form 2119* allows only the actual gain to be excluded. If the entire $125,000 is not excluded in a transaction, the unused portion is forfeited forever. The taxpayer must decide whether to take whatever exclusion can be deducted or delay the election until some possible future transaction when the benefit may be larger.

Farmers, ranchers and some other taxpayers who use property partly as their home and partly for business have a slightly more complicated situation than illustrated above. If the whole property is sold, taxes can be postponed or excluded on only that part of the gain resulting from the sale of the home.

To make these computations, you must allocate selling price, basis, selling expenses and fixing-up expenses between the residence (including land and outbuildings associated with the home) and business property. Taxpayers involved in this kind of sale should seek professional assistance from a tax expert to make these allocations.

Conclusion

Since the tax laws related to the provisions, definitions and limitations are complex and subject to continuous interpretation, this publication should not be used for making final tax decisions nor should it be viewed as a complete explanation. Expert tax advice is strongly recommended in all tax decisions and tax planning.

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