Keep Records of Any Improvements As They May Increase Your Cost Basis

Taxes After You Sell Your Home

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One of the primary financial stories of the past two years has been the rapidly changing housing market. A shortage of homes for sale and a lack of new home construction, along with historically low interest rates, has led to a rapid increase in housing prices. By one measure, home prices have risen more than 20% nationwide in the last year, on top of significant gains from the previous year.

At the same time, many people are rethinking their current living arrangements, choosing to relocate, downsize or even purchase a second home. Since each of these decisions comes with tax consequences, we thought it was a good time to review the details of taxes and home ownership.

For the purposes of this article, we'll only touch briefly on rental properties, which carry their own set of tax regulations that are too complex to fully address here.

Tax Consequences When Selling Your Home

Similar to the consequences of selling a stock or bond, when you sell your home you may be subject to capital gains tax on the amount of the gain. However, the similarities end there.

First, unlike an investment in a stock or bond, if your home price declines and you sell the home at a loss, you won't be able to deduct the realized loss on your taxes.

Fortunately, given the red-hot housing market, this isn't a problem for many!

Second, the Internal Revenue Service excludes a certain amount of your gain from taxation. The exclusion for a gain is $250,000 for a single person or $500,000 for a married couple for your primary residence.

In the past this meant that the vast majority of home sales were tax-free, but with the recent run-up in prices, many retirees who bought their homes 30 years ago may be facing an unpleasant surprise when they sell their home.

This exclusion applies only to a primary residence and certain rules must be met to qualify for the exclusion. Before we examine the rules around the gain exclusion, it is important that we understand how to calculate the gain itself.

How to Determine Basis

To discuss how to compute gains and losses, first we must explain the concept of "basis." The tax basis of real estate is the cost of the purchase, plus the cost of improvements to the property.

First, start with the original purchase price, including purchase costs paid at the time you bought the house (title and fees, real-estate commissions, etc.). Next, add the cost of improvements you've made over the years. In order to be added to basis, the improvements should be permanent changes to the home.

This could be big-ticket items like a deck, a new furnace or new windows, or smaller improvements such as new doors, carpets or countertops. Maintenance items like painting and cleaning can't be added to your basis.

Significant, permanent landscaping changes like a new walkway or retaining wall can be added to basis, while ongoing maintenance can't. Finally, if you ever took the home office deduction on your tax return, you must subtract from basis any depreciation expense that you claimed over the years.

Exclusion for Gains

Once you've calculated your basis, you can than calculate your gain or estimate your gain based on the price you expect to receive when you sell your home. As noted above, the home sale exclusion for a gain is $250,000 for a single person or $500,000 for a married couple filing joint, and applies only to your primary residence.

In order for your home to qualify as your primary residence, you must have owned and lived in the house for at least 24 months in the last five years. Those two years don't need to be consecutive. If you have moved multiple times, you can use this two-out-of-five-year rule to exclude your profits each time you sell or exchange your primary residence, provided you meet the two-year rule.

You can exclude a portion of your gain if you're selling your home and lived there less than two years and you meet one of the exceptions. You calculate your partial exclusion based on the amount of time you actually

lived in your home.

Exceptions are allowed if you sold your house because the location of your job changed, because of health concerns or for some other unforeseen circumstance. The IRS has given specific examples of unforeseen circumstances, including divorce, natural disasters, acts of war or terrorism or a change in employment that has left you unable to meet basic living expenses, among others.

In addition, widows and widowers get a special extension. A surviving spouse has two years from the date of a spouse's death to sell the home and use the full $500,000 joint gain exclusion.

Tax on Gains

If you do have a gain on the sale of your home over and above the exclusion, you will pay tax on the gains at your capital gains tax rate. For most taxpayers, the capital gains rate is 15%. But for those with high income (modified adjusted gross income over $459,751 for single filers, over $517,201 for joint filers), the capital gains tax rate is 20%.

In addition, there is a separate tax officially known as the net investment income tax, unofficially called the "Medicare surtax" that is applied to lower income thresholds. This tax kicks in for single filers with modified adjusted gross income over $125,000, or married filing joint over $250,000. Above those levels an additional 3.8% tax will be assessed on the gain over the exclusion.

Some Examples

We'll start with a married couple who bought their home in 1987 for $160,000. They've recently spoken to a Realtor, and expect to sell their home for $750,000, thanks to gains in the housing market over the past 35 years. They are retired and their adjusted gross income in retirement is around $100,000.

At first blush, it would seem their gain is $590,000 ($750,000 less $160,000). However, over the years they renovated the kitchen, installed new windows, a new roof and a new driveway. These and other improvements totaled $145,000. This amount should be added to their basis, giving them a total tax basis of $305,000. Thus, if the house were to sell for $750,000 net of all expenses, they would realize a total gain of $445,000 and they wouldn't owe any tax on the sale.

Conversely, let's look at a more affluent couple who bought their home for $480,000 in 1991 and recently sold it for $1.2 million. They are still working and have a modified adjusted gross income of $550,000. Their basis in the home, including improvements, is $600,000.

On the sale they will realize a gain of $600,000. Of that amount, $500,000 would be excluded from taxation, leaving $100,000 subject to capital gains. Their income level means that the $100,000 will be taxed at the 20% capital gains rate and also be subject to the 3.8% Medicare surtax. They will owe a total of $23,800 in federal tax on the sale.

Second Homes and Rental Properties

Second homes and rental properties generally do not qualify for the exclusion, and any gains on sales would be subject to tax. Here again, if you take a loss, you aren't able to benefit from the tax loss.

In the past, those with rental properties would employ a strategy where they moved into their rental property for two years establishing it as their primary residence and then sold the property, thus qualifying for the exclusion.

But the IRS has since closed this loophole. The IRS now uses a ratio of the years you occupied the home as a primary residence versus the years the home was used as a rental — or other-than primary residence — to calculate the amount of capital gains that will be excluded from the sale.

For example, take a homeowner who owned a rental property for eight years, and then moved into it for two years to convert it to a primary residence. If the homeowner sold at the end of the two-year residency and took a $100,000 profit, only $20,000 of the gain would qualify for the exclusion, as only 20% of the life of the property was a period of primary residence.

Conclusion

The housing market has had periods of boom and bust over the last 20 years. While in the past large taxable profits on home sales were rare, homeowners may face a different situation now. The ability to sell your home after a run-up in prices can be a significant windfall, but one that comes with tax consequences. As you can see, it is crucial to keep good records over the years. If you're thinking of selling in 2022, be sure to consult your accountant and financial planner. ß

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