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Please note that we are not accounts, and the information below should be verified with your CPA before making any decisions.

One reason real estate has soared as a private investment is the capital gains tax advantage it offers over other investment classes. With stocks and bonds, all long-term gains are now taxed at 15 percent. With sales of principal residences, individual sellers can exclude the first \$250,000 in profits from taxes; married couples filing jointly can exclude \$500,000.

To qualify, a taxpayer must have owned the house for at least two years and used it as a principal residence for two out of five years before the time it was sold. The two years don't need to be consecutive.

When a taxpayer owns more than one residential property, determining whether a house qualifies as a principal residence requires looking at how the property is used, as well as other circumstances, such as the owners' place of employment and where they receive their bills. If a taxpayer alternate's residence between two or more homes, the principal residence is ordinarily the one at which the taxpayer spends the majority of the year. Tax laws also allow a taxpayer to take the capital gains exclusion each time the two eligibility tests are met. A taxpayer could theoretically sell a principal residence once every two years-indefinitely-each time walking away with a tax-free gain.

Unfortunately, the \$250,000/\$500,000 exclusion, which was a significant amount of money at the time it was enacted as part of the Taxpayer Relief Act of 1997, wasn't indexed for inflation. Since then, home prices in the United States have increased significantly. Many taxpayers who have owned their home for years or reside in high-priced markets are shocked to learn they'll face big capital gains tax bills when selling their home.

For example, in 1995 Mary and Bob Jones purchased a single-family home for \$300,000 and used it as their principal residence. Four years later, they sold the home for \$900,000-a \$600,000 gain. They then purchased a new home for \$900,000.

Even though the Joneses used all their gain (and more) to buy a new home, only the first \$500,000 was excluded for capital gains tax purposes. At a capital gains tax rate of 15 percent, the Joneses faced a \$15,000 tax bill. The purchase of a replacement home in no way affects the tax consequences of the sale, though it did under previous tax law.

Lowering capital gains tax liability.

Let's begin by considering how capital gains are calculated. The capital gain on the sale of a home is defined as the amount realized on the sale minus the cost basis. The amount realized is the sales price minus selling costs. Selling costs include real estate commissions, legal fees, title and escrow fees, advertising, money spent to fix up the property just before sale, loan charges (such as loan placement fees or points), and real estate excise taxes. To calculate cost basis:

1. Start with the purchase price paid for the home.
2. Add these adjustments:
 - *Costs associated with the original purchase of the property.* These include abstract fees, recording fees, survey fees, title and escrow fees, attorney fees, real estate taxes owed, and inspection costs-but not points.
 - *Costs associated with major improvements to the property.* Major improvements are those that add to the value of your home, prolong its useful life, or adapt it to new uses. Finishing an unfinished basement, putting in new plumbing or wiring, or putting on a new roof would qualify. An addition, such as a deck, a sunroom, or a garage, is also an improvement. This category doesn't include the cost of routine maintenance or repairs.
3. Subtract decreases, such as
 - The gain postponed from the sale of a previous home (before May 7, 1997).
 - Deductible casualty losses, such as those caused by natural disasters.
 - Depreciation allowed or allowable if the home was used for business or rental purposes.

The resulting amount is the adjusted cost basis. Subtract the adjusted cost basis from the adjusted selling price (selling price minus selling expenses) to arrive at total capital gains.

Home owners should keep careful records to prove a home's adjusted cost basis for tax purposes. Information to keep could include proof of purchase price and purchase expenses, receipts for improvements that affect the home's basis, and any work sheets used to calculate the adjusted basis of a previous home that was sold.

Exceptions

Under certain circumstances, taxpayers may qualify for a hardship exception to help them lower their capital gains taxes, even if they haven't met the two year time requirement. Under the right conditions, hardships include a change of employment, health problems, and military service, according to the tax code. Military personnel who are required to live in government quarters or who are stationed at least 50 miles from their primary residence may have up to 10 years to meet the two-year residency requirement. The

hardship exception also applies to unforeseen circumstances, such as natural disasters and acts of war.

The favorable treatment of capital gains can be a good reason to invest in real estate. It can also be a motivation to sell and move on before the gain exceeds the allowable deduction.

Please remember to seek the advice of a tax adviser before making any tax-related decisions.

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