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Exclusions for the Sale of a House

Before May 7, 1997, there was a once-in-a-lifetime exclusion of up to $125,000 for individuals who sold their principal residence after the age of 55. Other taxpayers could postpone recognition of a gain by the purchase of replacement property within a 24 month period. Currently, when a primary residence is sold at a gain, an individual may exclude up to $250,000 of the gain from income. If a joint return is filed, the exclusion usually may be up to $500,000. Two basic rules apply:

1. The exclusion cannot be used more than once every two years.
2. The seller must have used the property as a principal residence for at least two years (730 days) during the five years immediately preceding the date of the sale.

However, there are circumstances where a taxpayer may be eligible for an exclusion even when they do not meet the two years residency requirement. To be eligible for a reduced maximum exclusion of gain, the taxpayer's reason for the sale or exchange must be:

1. A change in the place of employment
2. A change in health
3. Unforeseen circumstances

Factors that may be relevant in determining the taxpayer's primary reason for the sale include consideration of:

1. The primary reason is proximate in time to the sale
2. The property is materially unsuitable as the taxpayer's principal residence
3. The taxpayer cannot afford to maintain the property
4. The taxpayer used the property as his principal residence
5. The taxpayer could not reasonably anticipate the circumstances causing the sale when the taxpayer purchased the property
6. The circumstances causing the sale occurred while the taxpayer was using the property as the taxpayer's principal residence

The reason for the premature sale can be associated, not only with the taxpayer, but also with a member of the taxpayer's family or household, including the taxpayer's spouse, a co-owner of the residence, or anyone whose principal residence is in the household of the taxpayer.

If the sale or exchange is made for reasons of health, the circumstance

may also extend to any descendant's of the taxpayer's grandparents and a child, parent, aunt or uncle, or niece or nephew of one of the other qualified individuals.

Employment Reasons as a Basis for the Change

In order for a change of employment to qualify as a valid circumstance giving rise to the sale or exchange of the taxpayer's residence, the change in employment must occur while the taxpayer is using the property as a principal residence and the location of the new employment must be 50 miles further from the residence than the former place of employment.

Change of employment is defined as:

1. A new employer
2. Change of location of work for the same employer
3. Going from unemployment to employment
4. Start or continuation of self-employment

If there was no past employment the 50 mile criterion is applied to the distance between the residence and the new place of work.

Health Reasons for the Change

Essentially, a valid health reason is a change of residence to facilitate the diagnosis, cure, mitigation, or treatment of a disease, illness or injury of a qualified person. This may include moving to obtain medical or personal care required by the disease, illness or injury. If the move is made at the recommendation of a physician, the health reasons will automatically qualify.

Unforeseen Circumstances as a Reason for the Change

To qualify unforeseen circumstances must occur while the qualifying person is a resident of the property and must not be circumstances that could reasonably have been predicted before purchasing or occupying the residence. Many types of hardships can apply.

Certain defined safe harbors include:

1. Involuntary conversion of the residence
2. Disasters, acts of war, or terrorist attacks resulting in damage to the property

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Currently, when a primary residence is sold at a gain, an individual may exclude up to $250,000 of the gain from income.

Even if the taxpayer's reasons for the change do not meet exactly any of the above criteria, it is still possible to apply a "facts and circumstances" test to qualify for a reduced maximum exclusion

3. For any qualified individual:
    a. death
    b. cessation of employment when the qualified person is eligible for unemployment compensation
    c. a change in employment income or unemployment that results in the financial inability to pay housing costs and reasonable basic living expenses
    d. divorce
    e. multiple births resulting from the same pregnancy

Other Reasons for the Change

Even if the taxpayer's reasons for the change do not meet exactly any of the above criteria, it is still possible to apply a "facts and circumstances" test to qualify for a reduced maximum exclusion.

Calculating the reduced maximum exclusion

When taxpayers qualify for reduced maximum exclusion, the exclusion is calculated by multiplying the maximum dollar limitation of $250,000 ($500,000 for certain joint filers) by a fraction. The numerator of the fraction can be expressed in days or months.

It is the lesser of:

1. The days or months during which the taxpayer owned the property during the 5 year period preceding the sale or exchange of the property.
2. The period of time during which the property was the taxpayer's principal residence during the 5 year period preceding the sale or exchange of the property.
3. The period of time between the last time the taxpayer excluded gain under Internal Revenue Code 121 and the date of the current sale or exchane.

The denominator is either 730 days or 24 months.

For example, a couple filing jointly sold a house 14 months ago and excluded their gain by virtue of purchasing a new home 12 months ago. The taxpayer then was transferred by his employer from one office to another 100 miles away. The fraction to be used in the computation would be 12 months divided by 24 months. Multiplying $500,000 by ½ produces an allowable exclusion of $250,000, even though the taxpayers had used their home as their principal residence for less than 2 years from the sale of their previous home.

---John E. Litzinger, CPA

Editor's Note --- John is a Partner in the firm's Meadville Office. He presented the material included in this article originally as a component of tax seminars presented to other professionals and sponsored by the Land Grant University Tax Education Foundation, Inc.

Tax Implications for Related Parties

Controlled Groups of Corporations

A controlled group of corporations involves two or more related corporations. Many tax benefits must be aggregated and shared by members of a controlled group, including the following:

1. Graduated tax rate structure
2. Election to expense depreciable assets §179 deduction
3. AMT exemption
4. $25,000 general business credit

Controlled Groups are of two kinds. The Parent-Subsidiary controlled group involves one corporation owning at least an 80% interest in stock or assets of another corporation. The Brother-Sister controlled group involves a group of five or fewer shareholders having collectively at least an 80% interest of two or more corporations. A brother-sister group will then exist if the common ownership among them for both corporations is at least 50%.

Gains and Losses on Property Sales

In general a loss cannot be recognized on the sale of property to a related party. This disallowance applies to a group of companies with certain levels of common ownership, as well as to certain family members.

If there is a gain on the sale of property from one related party to another and the purchased property is depreciable by the purchaser, all of the gain must be recognized as ordinary income rather than capital gain by the seller.

Fringe Benefit Rules

Employees of all businesses, which are under common control, whether incorporated or not, must be aggregated to determine non-discrimination rules for employee benefit plans. For example, if three professionals form individual corporations, which in turn own another corporation for which their shared employees work, the professionals and the employees must be aggregated for application of the non-discriminatory rules.

Losses on Small Business Stock

Losses on the sale of stock are usually treated as capital losses. Capital losses are subject to significant limitations, individuals can only use $3,000 of capital losses annually to offset ordinary income.

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IRC Sec. 1244 allows ordinary loss treatment on the sale or worthlessness of certain small business stock. The maximum amount deductible as an ordinary loss in any year is $50,000 ($100,000 for a joint return). The loss is even considered a business deduction for NOL purposes. The 1244 ordinary loss is available only to individuals. Trusts and estates do not qualify.

To qualify as 1244 stock:

1. The issuing corporation must have been a small business when the stock was issued. A corporation is a "small business corporation" while its contributed capital and paid-in surplus does not exceed $1,000,000. The corporation can issue more than $1,000,000 in capital, but Section 1244 treatment only applies to the first $1,000,000 of stock/contribution of capital received by a corporation.
2. The stock must have been issued for money or other property (except stock or securities)
3. The corporation's gross receipts from investment property were not more than 50% of its aggregate gross receipts for its most recent 5 tax years that ended before the shareholder's loss.

A critical requirement to benefit from Sec. 1244 is that the investor must be the original holder of stock. The stock must have been purchased directly from the corporation. Any subsequent transfer, even a gift/transfer between spouses, disqualifies stock.

---Robert B. McMunigle, CPA, PFS

Editor's Note --- Bob is a Manager in the firm's Meadville Office. The article is derived from portions of a course that he taught as a component of tax seminars presented to other professionals and sponsored by the Land Grant University Tax Education Foundation, Inc.

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