Home, the Mother of All Tax Shelters (Part 2 of 2)

If the property was your principal residence for any two of the five years prior to sale, you can exclude from taxes $250,000 in gain (or $500,000 on a joint return). If you qualify under the 2-out-of-5 rule, you normally sign an affidavit at settlement. If the house sold for less than $250,000/$500,000, the sales amount isn't even reported to the IRS because you have no tax liability on that sale. This is no one-time exclusion. You don't have to buy a new house. You can even rent, and you can get another full exclusion every two years -- or whenever you qualify. But, if you have a $250,000/$500,000 gain every two years, I want to meet your real-estate agent and get in on the gold mine.

You can even get a partial exclusion based on the time of use and ownership. But you only get the partial exclusion if the sale is because of a change in place of employment, or health reasons, or certain unforeseen circumstances.

The partial exclusion is based on the maximum exclusion, not on the basis of your actual realized profit. So, say you bought a home for $250,000 and sold it because of a job change for a $25,000 profit after only one year. Because the sale was covered by a change in employment, you get a partial exclusion. It was your principal residence for one year out of two, so 50% of the maximum exclusion, up to $125,000 in total gain, is excluded. Since that's more than the $25,000 gain you actually realized, no tax is due on the sale. That's because you exclude half the maximum allowed, not the gain itself. It's a major tax break. Not many properties are going to appreciate more than $125,000/$250,000 in one year. The key is to qualify for the partial exclusion, if possible.

"Change in employment" covers anyone who lives in the household. The person doesn't even have to be an owner of the property. The "change in employment" must be the primary reason for the move. There's a "safe harbor" that assumes that it was the primary reason if your new job is at least 50 miles farther from the residence sold than where you used to work. But if you don't meet the "safe harbor," all is not lost. You'll just have to prove (if you're audited) that it was the primary reason for the move based on the facts and circumstances of your case.

“Health reasons” include advanced-age-related infirmities, the need to move to care for a family member, or to obtain or provide medical or personal care for a qualified individual suffering from a disease, illness or injury.

“Unforeseen circumstances” are where the IRS really became consumer-friendly. Safe harbors here include divorce, death, multiple births from the same pregnancy and even a change in employment or self-employment status that results in your inability to pay the costs and living expenses of your household. So, if your income goes down, or even if your spouse or other co-owner's income goes down, you can qualify for a partial or even a full exclusion. Even if you don't qualify for one of these "safe harbors," you might still qualify on the basis of your specific facts and circumstances.

The home office is where, in my opinion, the IRS actually crossed the line. But it was in favor of the taxpayer. So I'm not going to complain. Let's say you use 20% of your house as a home office, and you deduct depreciation and expenses for working in that part of the house. In the past, when you sold your house, 20% of the gain wouldn't qualify for the exclusion because that 20% wasn't used as a "residence." It was used exclusively as your office. And check IRS Publication 587 (pdf download) on home office deductions.

The IRS doesn't care even if you used your home 90% for business as a home office. You can now exclude as much as 100% of your gain, up to the $250,000/$500,000 limit. You're only going to be subject to tax on the gain to the extent of depreciation taken on the building since May 7, 1997. But that's taxed only at 25%.

Wow! That means that, if you qualify, there's no reason not to claim a home office. And I know there are any numbers of people who work out of their homes who don't claim home offices now.

Dorothy was right: "There's no place like home." At least, for now