

Exclusion of Gain on the Sale of a Principal Residence, Interest Deductions, Home Office Rules

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EXCLUSION OF GAIN ON THE SALE OF A PRINCIPAL RESIDENCE

A. Gain Exclusion

1. The first \$250,000 of gain (\$500,000 if married filing jointly) on the sale of a principal residence is usually not included in gross income (i.e. not taxable). I.R.C./121.
2. I.R.C./121 may be used only once every two years.
 - a. There is a relief provision which permits some of the \$250,000 or \$500,000 of the gross income exclusion to be used if the sale was caused by a change in place of employment, health, or, unforeseen circumstances. Examples of unforeseen circumstances given in the Regulations include death, divorce or legal separation, or multiple births from the same pregnancy occurring either to the taxpayer or certain other qualifying individuals including the taxpayer's spouse, a co-owner of the residence, or a dependent of the taxpayer. See Treas. Reg./1.121-3(e) and (f).
3. If the taxpayer was able to take depreciation deductions on the home because, for example, she had an office in the home or had rented the home during some of the 5 year testing period, the gain equal to the depreciation deductions is not excluded by I.R.C./121. This gain would typically be long term capital gain classified as unrecaptured I.R.C./1250 gain typically taxable at a rate of 25%.
4. I.R.C./121 can also apply to the sale of partial and remainder interests. See Treas. Reg./1.121-4(e).

B. Principal Residence

1. In plain English, the principal residence is the main place you live. If a taxpayer has more than one residence, generally the one he uses most of the time will be the principal residence. Treas. Reg./1.121-1(b)(2).
2. A residence can include a boat, a trailer, or an RV, or similar property in addition to a traditional home. See I.R.C./280A(f)(1) (except that this Code section's reference to other property appurtenant to the residence does not apply for I.R.C./121 purposes). See Treas. Reg. // 1.121-1(b)(1), -1(d)(2). A residence can include vacant land containing the selling the residence if the taxpayer owned and used vacant land as part of her principal residence. In some circumstances,

the Regulations permit the vacant land and the residence to be sold at different times and have both sales still qualify under I.R.C./121. See Treas. Reg./121-1(b)(2).

3. If the taxpayer uses part of a property as a principal residence and part for other purposes, only the principal residence part falls within I.R.C./121. For example, if part of a larger acreage contains both the residence, a barn, and horse stables, with the barn and horse stables used for business purposes, only the part of the property associated with the principal residence falls within I.R.C./121. If the entire property is sold, the taxpayer must allocate her basis and gain between the two parts of the property. Generally this will be done in the same manner as was used to determine depreciation adjustments. The same principles would apply if the taxpayer owns a multistory property and converts one floor of it into an apartment she rents out. See Treas. Reg./1.121-1(e).

C. Ownership and Use

1. The taxpayer must have (1) owned and (2) used the property as her principal residence for 2 of the prior 5 years ending on the date of the sale. Short absences such as for vacations or hospital stays count as use. Treas. Reg./121-1(c)(2)(i).
 - a. If a husband and wife make a joint return, the exclusion is available if either spouse meets the 2 year ownership requirement provided both spouses meet the 2 year use requirement and neither spouse has sold a principal residence within the last two years.
 - 1) If the spouses do not meet these requirements, either spouse is still generally entitled to the \$250,000 exclusion if he or she meets the relevant requirements. Further, each spouse is treated as owning the property during the time that either spouse owned the property.
 - b. If one spouse dies before the sale takes place, the period the surviving spouse is considered to have owned and used the property includes the period the deceased spouse did so, provided the surviving spouse has not remarried at the time of the sale.
 - c. I.R.C./1041(a) provides that no gain or loss is recognized on the transfer of property by a individual to a spouse or, if incident to a divorce, a former spouse. In the case of an individual who holds a principal residence that was transferred

to her under I.R.C. / 1041(a), the period the individual owns the property includes the period the transferor owned the property. Note this focuses on ownership not use. So the transferee still must *use* the property as a principal residence for 2 of the last 5 years, but need not necessarily have owned it for 2 years, as long as the transferor and the transferee together owned it for at least 2 years.

- d. An individual is also treated as using property as a principal residence during any period of ownership while that individual's spouse or former spouse is granted use of the residence under a divorce or separation instrument. This would cover the circumstance where someone kept ownership of the residence but was required to permit the ex-spouse to exclusively use it.
- e. If an taxpayer has used the property as a principal residence for at least 1 year during the 5 year testing period, and becomes physically or mentally incapable of taking care of herself, the taxpayer is treated as using the property as her principal residence during any time during the 5 year testing period in which the taxpayer resides in a nursing home or similar licensed facility.
- f. I.R.C. / 121 contains provisions that permit it to apply to a tenant-stockholder in a cooperative housing corporation.
- g. Special rules apply in the case of involuntary conversions such as condemnations.
- h. Ownership by a grantor trust or a one-person LLC (treated as a disregarded entity) counts as ownership by the taxpayer. Treas. Reg. / 1.121-1(c)(3). If the estate of a decedent sells the residence, I.R.C. / 121 will apply provided the decedent met the ownership and use requirements.
- i. There are special rules for members of the armed forces which can permit them to suspend the running of the 5 year period during any time they are on qualified official extended duty, i.e a duty station which is at least 50 miles from the residence. Similar rules can apply to members of the Foreign Service.

D. Exceptions

1. I.R.C. / 121 does not apply to certain expatriates who give up their citizenship to avoid U.S. taxes.
2. It does not apply if the taxpayer elects to have it not apply. This would be unusual, but might occur if the taxpayer has two residences he wants to sell, one with a small gain and one with a large gain where both qualify under I.R.C. / 121 (or within 2 years could be made to qualify).
3. It does not apply if the residence was acquired in a like-kind exchange under I.R.C./1031 and it sold within 5 years of that exchange.

INTEREST DEDUCTIONS

A. General

1. Deductions for interest expenses are covered by I.R.C./163.
2. Interest incurred on bona fide borrowed funds used in a trade or business is usually fully deductible. I.R.C./163(a)
3. Interest incurred on borrowed funds used to acquire investments is only deductible to the extent of a taxpayer's net investment income. I.R.C./163(d)
4. Interest on borrowed funds used to acquire a primary residence or a second residence, qualified residence interest is also deductible, subject to certain limitations.
5. Most other interest expenses incurred by individuals, what the Code calls personal interest, are not deductible.
6. Only interest incurred for the current year is currently deductible. If interest is prepaid, the portion paid for future years must be capitalized and is deductible in the year to which it is allocable I.R.C./461(g). There is an exception for points paid for a loan used to purchase or improve a principal residence (see below).
7. The code generally requires taxpayers to charge a minimum amount of interest on the loans. The amount varies depending on prevailing rates and the length of the loan term. If this is not done, all hell breaks loose (also known as the original discount rules). See I.R.C. // 483, 1272 7872. Trust us, you don't want to go there. Make sure you charge enough interest. The IRS publishes what the minimum interest rates are.

B. Trade of Business Interest

1. Generally, fully deductible, subject to the passive loss rules of I.R.C./469.

C. Investment Interest

1. I.R.C./163(d) imposes a limitation on an individual's ability to deduct interest for borrowed funds used to acquire an investment. Investment interest does not include interest taken into account in determining the taxpayer's income and loss from a passive activity.

2. Interest is only deductible to the extent of the taxpayer's net investment income.
 - a. Interest that exceeds the net investment income is carried forward and can be used in future tax years under the same rules until the taxpayer dies. It is one of the few things you can take with you when you go.
 - b. Generally, net investment income is investment income over investment expenses.
 - c. Investment income generally includes interest, royalties, short term capital gains in excess of short term capital losses, and certain elected dividends, provided none of this income is earned in the ordinary course of a trade or business
 - d. Net long term capital gains in excess of net short term capital losses (net capital gains) from the sale of investment property generally do not qualify as investment income. Individuals, however, may elect to treat net capital gain as investment income at the price of having that gain taxed at ordinary income tax rates (maximum 35%) instead of favorable long term capital gain rates (usually 15%). I.R.C./163(d)(4)(B).
 - e. Most dividend income is qualified dividend income and is taxed at the same rate as net capital gains, typically 15%. However, a taxpayer may elect to treat dividend income as investment income for I.R.C. / 163(d) purposes, in which case the dividend income is taxed at ordinary income rates (maximum 35%). I.R.C./1(h)(11)(D).
3. Investment interest is not deductible if incurred on debt used to carry tax-free or near tax-free investments (e.g. tax exempt municipal bonds, borrowings from a whole life insurance policy). See I.R.C./264(a)(2), 265(a)(2).

D. Qualified Residence Interest

1. Is also deductible. I.R.C. / 163(h)(3). Note that this is an exception to the general rule of I.R.C. / 262(a) that there is no deduction for personal, living, and family expenses.
2. Qualified residence interest consists of interest paid on acquisition indebtedness and home equity indebtedness.

- a. Acquisition indebtedness is any debt which is incurred to acquire, build, or substantially improve a qualified residence and is secured by the residence.
 - 1. It also includes any refinanced acquisition indebtedness, but not in excess of what was owed on the acquisition debt that was refinanced.
 - 2. Acquisition indebtedness on all qualified residences in the aggregate cannot exceed \$1,000,000 (\$500,000 in case of a separate return filed by a married individual).
- b. Home equity indebtedness is any indebtedness secured by a qualified residence that is not acquisition indebtedness. In the aggregate, the amount of such indebtedness cannot exceed the fair market value of the qualified residence reduced by the acquisition indebtedness secured by that residence (i.e. in the equity in the residence).
 - 1. Home equity indebtedness can also not exceed \$100,000 (\$50,000 in case of a separate return filed by a married individual).
- 3. A qualified residence is the principal residence of the taxpayer as defined in I.R.C. / 121 (i.e. the main place the taxpayer lives) and one other residence that the taxpayer selects that is used by the taxpayer as a residence within the meaning of I.R.C. / 280A(d)(1) (i.e. used as a residence for more than the greater of 14 days or 10% of the days the residence is rented at a fair market value rental).
 - a. If a taxpayer does not rent a dwelling at any time during the taxable year, he may treat the dwelling as a qualified residence even if he does not use it for 14 days. I.R.C. / 163(h)(4)(iii).
 - b. A residence can include a boat, a trailer, or an RV, or similar property in addition to a traditional home. See I.R.C. / 280A(f)(1) and Treas. Reg. // 1.121-1(b)(1), -1(d)(2).

HOME OFFICE DEDUCTION

A. General

1. Generally, taxpayers are not allowed deductions for using their home for business purposes. The home office deduction is an exception. I.R.C./280A(c).
2. Home-related expenses may be deductible to the extent they are allocable to a portion of a home exclusively used on a regular basis
 - a. as the principal place of business for any trade or business of the taxpayer,
 - 1) This includes a place of business which is used by the taxpayer for administrative or management activities of any trade or business of the taxpayer if there is no other fixed location of that trade or business where the taxpayer conducts substantial administrative or management activities. This provision overrules the holding in *Comm r v. Solimon*, 506 U.S. 168 (1993). There an anesthesiologist who traveled from hospital to hospital and had no office outside the home, used an office in his home exclusively for administrative purposes. The Supreme Court denied an home office deduction, and Congress responded with this provision.
 - b. as a place of business which is used by patients, clients, or customers in meeting or dealing with the taxpayer in the normal course of his trade or business, or
 - c. in the case of a separate structure which is not attached to the selling unit, in connection with the taxpayer's trade or business.
 - 1) This is a somewhat relaxed standard. In *Heineman v. Comm r*, 82 T.C. 538 (1984), the chief executive office of a large corporation was allowed a deduction for separate structure he built next to his Wisconsin vacation home. He used the office exclusively for the review of long-range corporate plans and for other corporate work.

3. If the taxpayer is an employee, the business use of the home must be for the convenience of the employer, i.e. there must be some direct benefit to the employer to having the employee work in this home office as opposed, for example, to the employer's business office.
4. A conceivable way to end-run the system would be to have an employee rent part of his home to his employer. I.R.C. § 280A(c)(6) disallows deductions in this event.
5. Deductions are available for the portion of the home regularly used for the storage of inventory and product samples, even if the space is not used exclusively for business purposes, provided the home is the sole fixed location of the trade or business. There is also a special exception for licensed day care operators.
6. The tax benefit that the home office deduction makes available is depreciation (and other home-related expenses such as utilities) on the portion of the home used as a home office. For example, if the home office constitutes 10% of the home, 10% of the basis of the home (but not the land on which it sits) can be depreciated. There are, however, limits on the deduction of these expenses. The amount of these expenses that can be deducted in a tax year cannot exceed:
 - a. Gross income derived from the use of the home office over
 - b. The sum of
 - 1) The deductions allocable to such use which are allowable regardless (e.g. interest deduction on mortgage and real estate taxes if 10% of the home is the home office, 10% of the interest deduction and taxes would be in this category), and
 - 2) The deductions allocable to the trade or business activity in question but not allocable to the physical use of the home, per se, such as secretarial expenses and office supplies.
 - c. If the remaining gross income is insufficient to absorb the relevant depreciation and other home-related expenses for a given tax year, the disallowed portion is carried forward and may be used in a future year under the same rules.
7. There is no deduction for the first phone line to a home. The cost of additional phone lines may be deductible. I.R.C. § 262(b).