Residences and Vacation Homes

Tax and Business Update

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Excluding Residence Gain

A taxpayer can exclude up to $250,000 of gain on the sale of his principal personal residence. Married couples and many surviving spouses can exclude up to $500,000.

- Taxpayers generally must have *owned* and *used* the property as their principal residence for periods totaling at least two years out of the five-year period ending on the date of sale.
- Whether a home is the taxpayer's principal residence depends on the facts and circumstances. A houseboat, trailer or stock in a housing co-op can qualify as a principal residence.
- Taxpayers must not have used the exclusion within the two-year period ending on the date of sale.
- For married couples filing jointly, the $500,000 exclusion is available if at least one spouse satisfies the ownership test and both spouses satisfy the use and frequency of sales tests.

Reduced exclusion. Taxpayers who do not meet the two-year ownership and use test, or who use the exclusion more than once in a two-year period, may qualify for a reduced exclusion. Reduced exclusion rules apply when the primary reason for selling the home is one of the following.

1) *Job relocation.* Applies to both employees and self-employed individuals. There is a 50-mile minimum distance safe harbor.
2) *Health problems.* The primary reason for selling is to obtain diagnosis or treatment of an illness or injury of an owner or resident.
3) *Unforeseen circumstances.* The primary reason for the sale is the occurrence of an event that the taxpayer could not reasonably have anticipated before purchasing and occupying the residence.

Unforeseen circumstances include sales because of:

- Involuntary conversions.
- Natural or man-made disasters or acts of war or terrorism.
- Death.
- Cessation of employment (if individual qualifies for unemployment compensation).
- Change in employment or self-employment status that results in the person's inability to pay basic living expenses.
- Divorce or legal separation.
- Multiple births resulting from the same pregnancy.

Vacation Homes

Special rules apply for reporting rental income and allocating expenses for homes that are used both for personal use and as rental property (mixed use). The allocation is based on the number of days of personal use and the number of days rented during the year. Deduction limits are based on whether the property is considered (1) a *personal residence*, (2) *rental property* or (3) a *dwelling unit used as a home*.

- Only actual days of personal and rental occupancy are counted.
- Days of vacancy are ignored.
- Days the owner spends principally on repairs and maintenance are not considered personal-use days.

See the table *Tax Rules for a Mixed-Use Home* on the next page.

Tax Rules for a Mixed-Use Home			
Tax Classification	**Personal-Use Property**	**Rental Property**	**Dwelling Unit Used as a Home**
Amount of Personal Use	More than 14 days of personal use and rented 14 days or less.	No more than the greater of (1) 14 days or (2) 10% of the number of days rented at fair rental value.	More than the greater of (1) 14 days or (2) 10% of the number of days rented at fair rental value.
Rental Income	Not reported.	All reported on Schedule E.	All reported on Schedule E.
Mortgage Interest	All deducted on Schedule A, if taxpayer's principal or qualified second home.	Portion allocated to rental activity deducted on Schedule E.[1] Personal-use portion nondeductible.	Portion allocated to rental activity deducted on Schedule E. Personal-use portion deductible on Schedule A, if taxpayer treats this as a second home under mortgage interest rules.
Property Taxes	All deducted on Schedule A.	Portion allocated to rental activity deducted on Schedule E.[1] Personal-use portion deductible on Schedule A.	Portion allocated to rental activity deducted on Schedule E. Personal-use portion deductible on Schedule A.
Expenses Directly Related to Rental	Nondeductible.	Deducted on Schedule E.[1]	Deducted on Schedule E.
Other Rental Expenses	Nondeductible.	Portion allocated to rental activity deducted on Schedule E.[1] Personal-use portion nondeductible.	Portion allocated to rental activity deducted on Schedule E, but limited to gross rental income, less the expense items in the preceding rows. Personal-use portion nondeductible.

[1] May be subject to passive activity loss limits.

Converting a Residence to Rental

A taxpayer may decide to permanently convert a personal residence to rental property.

Depreciation. When a personal residence is converted to rental use, its basis for depreciation is the lower of the property's:

1) Adjusted basis on the date of conversion or

2) FMV at the time of conversion.

Property converted from residential to rental use is depreciated straight-line over 27.5 years.

Excluding gain on converted property. Converting a residence to rental property does not automatically preclude exclusion of the gain under the rules for a sale of a principal residence.

Strategy: If a homeowner has owned and used the home as a principal residence for at least two years, he can convert the home to rental property for up to three years before selling it and still meet the two-of-five-year ownership and use tests for excluding the gain.

Effect of rental use on the gain recognized. Any gain attributable to post May 6, 1997 depreciation (from rental or business use of a principal residence) cannot be excluded. This gain generally is subject to a maximum 25% tax rate.

When the principal residence is sold, the entire home is treated as a single property for the gain exclusion if the residential part and the part rented out or used for business are within the same dwelling unit. Otherwise, the sale is treated as two separate sales.

Example: For the entire time he owned his main home, Martin used a detached garage solely as his office. After owning it for four years, Martin sold his home for a $75,000 gain. The garage does not qualify for the gain exclusion because it was not in the same dwelling unit as Martin's main home. Martin must treat this as two separate sales by allocating the sales proceeds between the garage and the rest of the property. Any gain attributable to his dwelling unit is eligible for the exclusion. The gain attributable to the garage is taxable.

Variation: Assume the same facts, except Martin's home office was in a spare bedroom within the home. Because the office was located within the same dwelling unit, Martin can exclude the entire gain when he sells the home (except to the extent of the depreciation allowable on his office).

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