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NEWSLETTER

NOTE: If you think your colleagues would benefit from this NEWSLETTER, please forward it to them and ask them to reply to me by email for inclusion in this free Newsletter.

Also, if you have a topic you would like me to analyze and discuss, please email me and I would be glad to consider it in a future Newsletter

May 2016 NEWSLETTER

Very often realtors ask the closing attorney whether or not the sellers of a particular home will have to pay capital gains tax on the sale. While I cannot give tax advice (that is the province of a CPA), I can explain the tax consequences of the most common sale situation. I caution you that your clients should confirm what I am saying with their own tax advisor since there are so many factual variations to the question.

Your clients will <u>not</u> have to pay a capital gains tax if they can answer <u>YES</u> <u>to all the following 5 questions:</u>

1. **The clients owned and used the property as their primary residence for at least 2 of the last 5 years ending on the date of the closing. The 2 years do not have to be consecutive; <u>AND</u>**
2. **As of the closing date, the clients had not sold another principal residence within the past 2 years; <u>AND</u>**
3. **The clients have not used the house for rental or business purposes after May 6, 1997; <u>AND</u>**

4. **The clients did not acquire the house through an IRC § 1031 tax-free exchange; <u>AND</u>**
5. **At least 1 of the following 3 statements are true:**
    a. **the sales price is $250,000.00 or less; <u>OR</u>**
    b. **The clients are married, the sales prices is $500,000.00 or less and the <u>gain</u> on the sale is less than $250,000.00; <u>OR</u>**
    c. **The clients are married, the sales prices is $500,000.00 or less and (a) they intend to file a joint tax return and (b) both spouses used the house as their primary residences for 2 out of the last 5 years** and (c) neither spouse has sold another principal residence during the 2-year period ending on the closing date.**

****(b) means that both husband and wife must pass the use test; that is, each must live in the residence for two years. But the shared use doesn't have to be while they file jointly. If your clients shared the home for 1½ years before marrying and then six months as newlyweds, the IRS will allow them to claim the exemption.**

Also, there is no limit on the number of times the Sellers can use the home-sale exemption. In most cases, Sellers can make tax-free profits of $250,000 (or $500,000 depending on filing status) every time they sell a home.

Another important question is how you determine the GAIN on a sale of a house, especially if 5b. applies. To answer this question, Sellers must differentiate between IMPROVEMENTS and REPAIRS. Simply put, Sellers can add the cost of all home improvements to the price they paid for the house. The result is your client's <u>basis</u> in the house. For example, if your clients paid $150,000.00 for the house and made improvements costing $125,000.00, the <u>basis</u> in the house is now $275,000.00. If they sold the house for $500,000.00, their gain is $225,000.00. If they can answer YES to all 5 questions, there is no capital gains tax!

What is an IMPROVEMENT as opposed to a REPAIR?

The IRS in Publication 530 states the distinction as follows:

Improvements. An improvement materially adds to the value of your home, considerably prolongs its useful life, or adapts it to new uses. You must add the cost of any improvements to the basis of your home. You cannot deduct these costs. Improvements include putting a recreation room in your unfinished basement, adding another bathroom or bedroom, putting up a fence, putting in new plumbing or wiring, installing a new roof, and paving your driveway.
Amount added to basis. The amount you add to your basis for improvements is your actual cost. This includes all costs for material and labor, except your own labor, and all expenses related to the

improvement. For example, if you had your lot surveyed to put up a fence, the cost of the survey is a part of the cost of the fence.

Repairs versus improvements. A repair keeps your home in an ordinary, efficient operating condition. It does not add to the value of your home or prolong its life. Repairs include repainting your home inside or outside, fixing your gutters or floors, fixing leaks or plastering, and replacing broken window panes. You cannot deduct repair costs and generally cannot add them to the basis of your home.

However, repairs that are done as part of an extensive remodeling or restoration of your home are considered improvements. You add them to the basis of your home.