Home Sale Gain Exclusion Explained

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As you plan for your posting back from overseas to the United States, you must often decide where to live in the Washington DC area, and whether to rent or buy. If you buy, it's helpful to understand the home sale gain exclusion provisions of the tax code and the special provisions for Foreign Service Officers. These provisions could save you substantial amounts in tax payments if you buy and sell property to accommodate changing family circumstances across multiple assignments in the Washington DC area.

Clients have asked us about these provisions, therefore we offer the following explanation of the home sale gain exclusion under the tax code.

Section 121

Section 121 of the tax code provides that a taxpayer may exclude from gross income any gain up to $250,000 if single ($500,000 if married and filing jointly), realized on the sale (or exchange) of property that the taxpayer owned and used as a principal residence. A taxpayer may exclude gain only if, during a five year period ending on the date of the sale (or exchange), the taxpayer used the property as a principal residence for periods totaling two years or more. In order to take advantage of the exclusion then, **the basic rule is you must reside in the home for 2 out of the 5 years preceding the sale**. But this rule is modified for Foreign Service Officers as explained below.

Special Exemption for Foreign Service Officers

Foreign Service Officers on qualified official extended duty, for example, a posting to an overseas embassy or mission, can also suspend the 2 in 5 rule for up to 10 years. **This special exemption modifies the basic rule so that you must reside in the home for 2 out of the 15 years preceding the sale.**

Tax on Unrecaptured 1250 Gain

Unfortunately, the Section 121 exclusion does not apply to the portion of the gain on sale of the home resulting from depreciation allowed or allowable during periods of rental use (referred to under the tax code as the unrecaptured 1250 gain). This portion of the

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gain will usually be taxed at the long-term capital gain rates of 0%, 15%, 20%, or 25% depending upon your income and your tax bracket. Thus, if you rent out your home and claim depreciation expense on your annual tax return, **the cumulative amount of this depreciation expense will always be taxed upon the sale of the property**.

Example

For example, let us assume that while on assignment in Washington DC, you purchased a condominium for $300,000 on June 30, 2010, and were then posted overseas to Embassy Madrid on June 30, 2014. Let us assume further, that you take back-to-back overseas assignments in Spain and Chile, returning for a posting at main State in the summer of 2020. You then sell your condominium for $500,000, net of selling costs, on June 30, 2020, resulting in a capital gain of $200,000. During the six years you rented your condominium out to third parties, you took annual depreciation charges of $10,000, for total depreciation expenses of $60,000.

On the date of sale, you will have used the condominium as a principal residence for only 4 out of the previous 10 years, but you may exclude 6 of those years because you were on qualified official extended duty - posted to overseas embassies on orders from the State Department. Therefore, you can exclude the $200,000 from your gross income, but must report and pay tax on the $60,000 of total depreciation charges, or <u>unrecaptured 1250 gain</u>.

Reporting the Sale

If you have a gain but the entire gain is excludable from income, you do not have to report the sale on your tax return unless you receive a Form 1099-S from the settlement agent. In this case, you report the sale on IRS Form 8949. You must also report the sale on Form 8949 if you have a taxable gain and did not receive a Form1099-S, or you receive Form 1099-S and either you have a gain that cannot be excluded or you decide not to claim the exclusion. You might decide not to claim the exclusion if you are selling two residences and wish to reserve the exclusion for the one on which you could exclude the largest gain.

If you can exclude all or part of your gain and must use Form 8949, you claim the allowable exclusion by entering code "H" in column (F) of IRS Form 8949 and by entering the exclusion as a negative adjustment in column (G). You would complete the Schedule D tax worksheet to compute the tax to be paid on the $60,000 of <u>unrecaptured 1250 gain</u>.

You may use the Section 121 exclusion as often as every two years. Further, because the gain is excluded from gross income, you are less likely to trigger the net investment tax of 3.8%, which is assessed on the lesser of your net investment income, and the amount by which your modified adjusted gross income exceeds the statutory threshold amount based on your filing status ($200,000 if single; $250,000 if married). Net investment income includes, among other items, interest, dividends, and capital gains on portfolio assets.

Bottom Line: You could conceivably return for multiple tours at main State over many years, building equity through successive home purchases, each best suited to your family circumstances. <u>HOWEVER</u>, you must have a cooperative real estate market, one that each time allows you to sell (net of selling costs) for a gain and not a loss. *Losses on home sales are not tax-deductible.*