The Washington Post

THE COLOR OF MONEY

Michelle Singletary

An Expert Weighs In on Housing Tax Issues

September 1, 2005

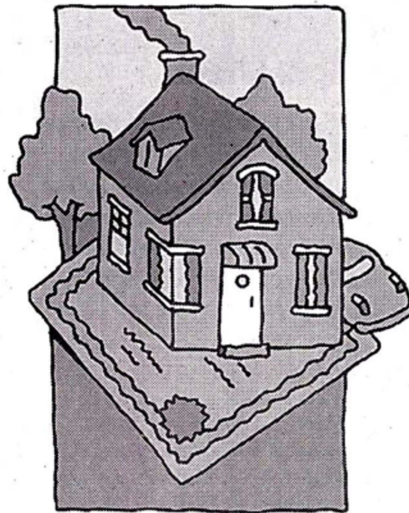
In a recent column, I covered several mistakes that amateur real estate investors make because they misinterpret tax issues on their investment.

Primarily I addressed two sections of the U.S. Tax Code — Internal Revenue Code 121 and Internal Revenue Code 1031.

Under IRS Code 121, homeowners can keep a gain of up to $250,000 ($500,000 per married couple filing jointly) tax-free when selling their principal residence. To qualify for the tax exemption, you must have owned and occupied your residence for two of the five years before the sale.

IRS Code 1031 is a way to defer paying the capital gains tax on the sale of an investment property. Generally, the law allows the exchange of an investment property for another investment property of the same or greater value.

Well, those two favorable tax codes generated quite a bit of mail from readers. So, Lonnie Davis, a certified public accountant and director of CBIZ Accounting, Tax & Advisory Services in Philadelphia, agreed to answer some of the questions.



BY SEYMOUR CHWAST

Q: I sold an investment property as part of a 1031 exchange. I am interested in replacing the investment property with an apartment in New York City. However, I must live in the apartment for the first year before renting it out. I understand that I am not supposed to use a primary residence in the 1031 process but I really want this particular apartment. How can I make this transaction work?

A: This transaction would not qualify for Section 1031, Davis said. "You could seek a waiver from the apartment's homeowners association, but if you live in the apartment after its acquisition, the gain on the property sold would be taxable."

Q: I bought a condo last year and will be forced to sell it this fall because I must change jobs and move to a new city. I take it that this means that I will be unable to exclude the gain on the sale?

A: Not necessarily so, says Davis. If you are forced to sell your principal residence before meeting the two-year minimum occupancy rule under IRS Code 121, you may still be eligible for a partial "hardship" exclusion of a gain. The amount of the gain you can exclude would be reduced by the percentage of time that you did not live in the home for two years, Davis said.

According to Davis, the reduced tax exclusion could apply if a change in your employment takes you at least 50 miles farther from your home than your former place of employment (or if you are unemployed, the distance between your new place of employment and the home you sold is at least 50 miles).

You may also be eligible to exclude some of your gain if you have to move because of health reasons. Specifically the IRS says the exemption is valid if you sell your home to "obtain, provide or facilitate the diagnosis, cure, mitigation or treatment of a disease, illness or injury of a qualified individual." However, the IRS says the health exclusion can't be used if the sale "merely benefits a qualified individual's general health or well-being."

Additionally, you may be eligible for a partial exclusion because of "unforeseen circumstances" such as a death or divorce. This is a tricky area of tax code, so read IRS Publication 523, "Selling Your Home," for guidance on which unforeseen circumstances qualify for a partial exemption.

To calculate how much of the capital gain you can exclude, use the worksheet that can be found in Publication 523. You can find the publication at *www.irs.gov* or call the IRS's toll-free tax assistance line at 800-829-1040.

Q: I may be applying to business graduate school for entry in fall 2006. Assuming I get into school and need to move, can I sell my condo and be exempt from any tax on the gain? I will not have lived there two years but heard that graduate school may be a valid reason for the sale to be tax exempt.

A: "Graduate school is not expressly stated as one of the hardship exclusions to IRS Code 121," Davis said.

Q: My name is on the title and mortgage. The home is in Washington, D.C. My "common law" wife and I want to sell. Are we entitled to the $500,000 exclusion?

A: "In order for you to avail yourselves of the $500,000 exclusion, you would have to file joint tax returns," Davis said. However, you could get married and claim the exclusion as long as you could meet the residence test. Also, you could deed one-half of the property to your "common law" wife, and you both could take $250,000 each on separate tax returns.

Q: To make a 1031 exchange, how alike must the properties be?

A: According to the IRS, properties must be "like kind," meaning they are of the same nature or character, even if they differ in grade or quality. So, for example, unimproved land can be exchanged for improved income-producing property, assuming all other requirements of Section 1031 are followed, Davis said. For more information about like-kind exchanges, see IRS Publication 544, "Sales and Other Dispositions of Assets."

As you can see, there are a lot of exceptions and exclusions when it comes to taxation of real estate gains. Use these answers as a guideline, but for advice on your specific situation, consult a tax professional.

■ **On the air:** *Michelle Singletary discusses personal finance Tuesdays on NPR's "Day to Day" program and online at www.npr.org.*

■ **By mail:** *Readers can write to her at The Washington Post, 1150 15th St. NW, Washington, D.C. 20071.*

■ **By e-mail:** *singletarym@washpost.com.*

Comments and questions are welcome, but because of the volume of mail, personal responses are not always possible. Please note that comments or questions may be used in a future column, with the writer's name, unless a specific request to do otherwise is indicated.