# Capital Gains Tax

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## I. Introduction

This Q&A outlines the basic rules for payment of capital gains with particular emphasis on the capital gains exclusion for a person selling their primary residence. The Tax Cuts and Jobs Act (TCJA) passed in December of 2017 did not change this exemption. Nor did it change the long-term capital gains rates, the recapture rates, nor even the rules pertaining to 1031 tax-free exchanges for real property held for investment or trade, despite proposed versions of the bill to the contrary.

Additionally, this article briefly discusses the net investment tax contained in the federal health care reform law known as "The Patient Protection and Affordable Care Act."

## II. Taxation on Sale of Principal Residence

### Q1. *What happens if I sell my principal residence?*

**A1.** Individuals are generally permitted to exclude from income up to $250,000 ($500,000, in general, for married couples filing a joint return) realized on the sale or exchange of their principal residence (26 U.S.C. § 121 also cited as IRC § 121).

### Q2. *May I use this exclusion more than once?*

**A2.** Yes, but generally not more than once every two years. In order to qualify, you must have owned and used the property as your principal residence for at least two years during

the five-year period ending on the date of the sale or exchange. In addition, the two-year periods do not have to be continuous. (IRC § 121.)

**Q3. *Didn't the Tax Cuts and Jobs Act passed on December of 2017 extend these periods to 5 out of the last 8 years?***

**A3.** No. Even though this provision was included in the House and Senate versions of the bill, N.A.R. was able to defeat it. Ultimately, the law remains unchanged, and the holding period of two of the last five years is still the law.

**Q4. *May I use this exclusion in connection with Internal Revenue Code ("IRC") section 1034 "rollover" of gain on the sale of my principal residence if I purchase a home of equal or greater value?***

**A4.** No. The IRC § 1034 provision allowing a delay in the recognition of gain when purchasing a replacement residence of equal or greater value was repealed by the 1997 Act (IRC § 121).

**Q5. *May I still take a one-time exclusion of $125,000 of gain from the sale of my principal residence if I am age 55 years or older?***

**A5.** No. This exclusion was also repealed by the 1997 Act.

**Q6. *If I have previously used the $125,000 exclusion of gain, am I prohibited from using the new $250,000 ($500,000 for married couples filing jointly) exclusion of gain?***

**A6.** Generally no. Even if you have previously taken the one-time $125,000 exclusion, if you are otherwise eligible for the exclusion you can take advantage of the $250,000 exclusion ($500,000 for married couples filing jointly) as often as you meet the requirements. (IRC § 121.)

**Q7. *How does the exclusion apply to married couples?***

**A7.** The $500,000 exclusion applies to married couples filing jointly when all of the following conditions are met:

Either spouse meets the ownership requirement;

Both spouses meet the use requirement; and

Neither spouse has had a sale of their principal residence in the preceding two years subject to the exclusion.

(IRC § 121.)

**Q8.** ***What if I marry someone who has used the exclusion within two years prior to our marriage?***

**A8.** Even though your spouse has used the exclusion within two years prior to your marriage, you would still be allowed a $250,000 exclusion. Once both spouses satisfy the eligibility requirements and two years have passed since the last exclusion was allowed to either spouse, a full $500,000 exclusion would be allowed for the next sale or exchange of a principal residence. (IRC § 121.)

**Q9.** ***If my spouse dies, must I sell our principal residence within the year of my spouse's death in order to take advantage of the $500,000 exclusion from gain?***

**A9.** No. The 2007 Act amends IRC § 121(b) to allow the exclusion of $500,000 in capital gains tax if the principal residence is sold within two years of the spouse's death for all sales after December 31, 2007.

**Q10.** ***What if I move before I have occupied my residence for two years or before two years have elapsed since the last time I sold or exchanged my principal residence?***

**A10.** If you fail to meet either two-year requirement, you will still be entitled to a pro-rata amount of the exclusion as long as the failure to meet the requirement is because the sale or exchange is by reason of a change in place of employment, health, or other unforeseen circumstances.

The 1998 Act provides that this ratio is that portion of the $250,000/$500,000 exclusion equal to the fraction of the two years that the ownership and use requirement is met. Therefore, an unmarried taxpayer who owns and uses a principle residence for one year and then sells because of a job transfer may exclude up to $125,000 of gain (one-half of the regular $250,000 exclusion).

**Example:** Ms. Seller purchased and occupied her principal residence in 1998. One year later, she is transferred by her employer to another city and sells her house for a $100,000 gain. Because she occupied her residence for one-half of the required two years, Ms. Seller is entitled to exclude up to one-half of the $250,000 otherwise allowed, thereby covering her entire $100,000 gain. This is a change from the IRS's previous position allowing her to exclude only one-half of her gain, or $50,000.

**Q11.** ***Are there clarifications to the permissible reasons for sale or exchange allowing a pro-rata exclusion?***

**A11.** Yes. Treasury regulations provide clarifications and safe harbors for the exemptions from the two-year period. Treasury Regulation 1.121-3(b) provides that a sale or exchange is by reason of a change in employment, health, or unforeseen circumstances only if the

primary reason for the sale or exchange is a change in place of employment, health, or unforeseen circumstances. The regulation provides the following guidelines and safe harbors:

**Place of Employment**

Generally, a sale or exchange is deemed to be a change in employment if the primary reason for the sale or exchange is a change in the location of a qualified individual's place of employment. (See Question 11 for a definition of qualified individual.)

The regulation provides a distance safe harbor if (i) the change of employment occurs during the period of the taxpayer's ownership and use of the property as the taxpayer's principal residence, and (ii) the individual's new place of employment is at least 50 miles further from the residence sold or exchanged than was the former place of employment, or, if there was no former place of employment, the distance between the individual's new place of employment and the residence sold or exchanged is a least 50 miles.

For purposes of the regulation, employment includes starting a job with a new employer, continuing employment with the same employer, and starting or continuing self-employment.

**Health**

A sale or exchange is by reason of health if the primary reason for the sale or exchange is to obtain, provide, or facilitate the diagnosis, cure, mitigation, or treatment of disease, illness, or injury of a qualified individual, or to obtain or provide medical or personal care for a qualified individual suffering from a disease, illness, or injury. A sale or exchange that is merely beneficial to the general health or well-being of the individual is not a sale or exchange by reason of health.

The regulations provide a safe harbor if a physician recommends a change of residence for reasons of health. (See Question 11 for a definition of qualified individual.)

**Unforeseen Circumstances**

A sale or exchange is by reason of unforeseen circumstances if the primary reason for the sale or exchange is the occurrence of an event that the taxpayer does not anticipate before purchasing and occupying the residence.

The regulations provide a safe harbor for any of the following events occurring during the taxpayer's ownership and use of the residence as the taxpayer's principal residence:

1. Involuntary conversion of the residence;

2. Natural or man-made disasters or acts of war or terrorism resulting in a casualty to the

residence;

3. In the case of a qualified individual:a) death; b) the cessation of employment and eligible for unemployment compensation; c) the inability to pay housing costs and basic living expenses d) court ordered divorce or legal separation e) multiple births resulting from the same pregnancy.

4. An event determined by the Commissioner to be an unforeseen circumstance to the extent provided in published guidance of general applicability or in a ruling directed to a specific taxpayer.

(See Question 11 for a definition of qualified individual.)

(26 C.F.R. § 1.121-3.)

**Q12.** ***Who is a "qualified individual" as used in Question 10?***

**A12.** Qualified individual is defined in the regulations as the taxpayer, the taxpayer's spouse, a co-owner of the residence, or a person whose principal place of abode is in the same household as the taxpayer. For purposes of the pro-rata exclusion of gain for a sale or exchange due to health only, a qualified individual also includes (i) an individual with a relationship described as a dependent in IRC § 152(a)(1) through (8), without regard to whether they are actually a dependent, or (ii) a descendent of the taxpayer's grandparent. (26 C.F.R. § 1.121-3(f).)

**Q13.** ***What if I do not qualify for a safe harbor?***

**A13.** The regulations provide the following factors, which may be relevant in determining the taxpayer's primary reason for the sale or exchange:

1. The sale or exchange and the circumstances giving rise to the sale or exchange are proximate in time;
2. The suitability of the property as the taxpayer's principal residence materially changes;
3. The taxpayer's financial ability to maintain the property materially changes;
4. The taxpayer uses the property as the taxpayer's residence during the taxpayer's ownership of the property;
5. The circumstances giving rise to the sale or exchange are not reasonably foreseeable when the taxpayer begins using the property as the taxpayer's principal residence; and
6. The circumstances giving rise to the sale or exchange occur during the period of the taxpayer's ownership and use of the property as the taxpayer's principal residence.

(26 .F.R. § 1.121-3(b).)

**Q14.** ***May I deduct a loss on the sale of my principal residence?***

**A14.** No. Although there were discussions about allowing homeowners to deduct losses on the sale of their principal residence, this provision did not become law.

**Q15.** ***If I have gains from the sale of my principal residence above the $250,000/$500,000 exclusion limits, what tax rate will I pay?***

**A15.** Depending on the length of time you owned your principal residence, your gain may be taxed at the more favorable capital gain rates discussed below. See Section II, below.

**Q16.** ***Are there more special rules?***

**A16.** Yes, including, among others, the following:

A taxpayer can elect not to have the exclusion apply to any sale or exchange.

Certain periods an individual resides in a nursing home on account of physical or mental incapacity are included as part of the two-year use requirement if certain other rules apply.

An individual whose spouse is deceased on the date of the sale of the property can include the period the deceased spouse owned and used the property before death.

An individual is treated as using the property as his or her principal residence during any period of ownership while the individual's spouse or former spouse is granted use of the property under a divorce or separation instrument.

**Q17.** ***What happens if I transfer my principal residence into a revocable living trust?***

**A17.** IRC § 676 provides that a grantor (the person who creates and funds the trust) is treated as the owner of the property when the grantor retains the power to revoke the trust and re-vest title in him or herself. The 2003 Act does not change this provision. This means that the $250,000 exclusion ($500,000 if married filing jointly) applies to a sale or exchange by a revocable living trust so long as the grantor of the trust and owner of the property before it was conveyed to the trust are the same person and that person, either as owner or grantor, has owned and used the property as his or her principal residence for two of the previous five years. In other words, because the grantor is still treated as the owner of the property, the transfer into the trust is not a taxable event.

**Q18.** ***May I utilize an IRC 1031 ("like kind" tax-deferred exchange) in connection with an owner-occupied residence?***

**A18.** No. However, individuals sometimes exchange one rental property for another planning to move into the acquired property and, after living in it for two years, sell it and take advantage of the capital gains exclusion. This sometimes occurred as soon as three or four

years after the acquisition. As of October 22, 2004, this was no longer possible. Pursuant to the American Jobs Creation Act of 2004, a property acquired in a 1031 exchange and later converted to a principal residence must be owned for five years from the date of the exchange before the owner can claim the capital gains exclusion. Therefore, in order to take advantage of a 1031 exchange and the capital gains exclusion, the owner must both have used the acquired property as a principal residence for two years and owned it for five years.

**Q19.** ***Is the exclusion treated differently for the sale of a principal residence that was used as a second home or as income property during the ownership period?***

**A19.** Yes. For any periods of ownership occurring on or after January 1, 2009, under the Housing and Economic Recovery Act of 2008 (H.R. 3221), the exclusion from capital gains recognition will be reduced by the amount of time the property was not used as a principal residence ("non-qualified use"). The gain from the sale will be allocated between periods when the property was used as a principal residence ("qualified use") and periods of non-qualified use. The math is as follows: The gain is multiplied by a fraction where the top number (the numerator) is the period that the property was used as a principal residence (qualified use) and the lower number (the denominator) is the total period of ownership.

Gain x (Time of qualified use/Total time owned) = exclusion from capital gains (capped at $250,000 and $500,000).

**Example:** A married couple filing jointly purchased a vacation property on January 2, 2009 which they sell on January 2, 2017 for a gain of $600,000. During the last two years of ownership they occupied the property as their principal residence. They would divide 2 years of qualified use by 8 total years of ownership (1/4) and then multiply that by their gain of $600,000 (or 1/4 x $600,000 = $150,000). They could exclude $150,000 from capital gains (which is less than the $500,000 cap for joint filers) and the balance of the $600,000 gain, $450,000 would be taxed as capital gains.

**Q20.** ***Are there exemptions from the no- qualified use rules?***

**A20.** Yes. There are three exemptions from the non-qualified use rules:

1) Any portion of the 5-year ownership and use requirement occurring after the last date the property was used as a primary residence of the taxpayer or the taxpayer's spouse.

Some examples may help.

**Example One:**

In January 2009, married taxpayers filing a joint return buy a house and use it as their principal residence for the first two years. They then convert the residence to a rental for the next three years, after which they sell the residence and realize gain of $600,000. None of

the three years of otherwise non-qualified use after the initial use as a principal residence would be used to reduce the capital gains exclusion. They would be entitled to the full $500,000 exclusion and would owe capital gains on $100,000.

The formula would be the $600,000 gain times the five years of qualified use (the initial two-year qualifying use period plus the balance of the five-year qualifying ownership period following the two-year qualifying use period) over the five-year total ownership period.

$600,000 x 5/5 = $600,000 qualifying gain (capped at $500,000 for joint filers).

**Example Two:**

The same couple buys a house in January 2009 and rents it out for the first three years. They then convert it to their principal residence for the next two years. Following this they once again rent the residence out, this time for three years, after which they sell the residence for $600,000 gain. They owned the property for a total of eight years. They have three years of non-qualified use and five years of qualified use (the two-year qualifying use period plus the balance of the five-year qualifying ownership following the two-year qualifying use period).

The formula would be $600,000 gain times five years of qualified use over eight total years of ownership.

$600,000 x 5/8 = $375,000 excluded from capital gains and capital gains tax would be owed on $225,000.

**Example Three:**

The same couple buys a house in January 2009 and rents it out for six years. They then occupy it as their principal residence for two years and sell it for $600,000 gain. Since none of the five- year qualifying ownership period occurs after the two-year qualifying use period only the last two years of occupancy count as qualified use.

The formula would be $600,000 times 2 years of qualified use over 8 total years of ownership.

$600,000 x 2/8 [or 1/4] = $240,000 excluded from gain and capital gains tax would be owed on $360,000.

The other two exemptions from the non-qualified use rules are:

2) Any period (not to exceed an aggregate period of 10 years) during which the taxpayer or taxpayer's spouse is serving on extended official duty as a member of the Foreign Service or the uniformed services of the United States, and

3) Any other period of temporary absence (not to exceed an aggregate of two years) due to change of employment, health conditions, or other such unforeseen circumstances.

For more examples of calculating capital gains exclusions visit NAR's Web site at http://realtormag.realtor.org/sales-and-marketing/handouts-for-customers/for-sellers/understanding-capital-gains-in-real-estate

## III. Capital Gains Tax

**Q21.** ***What is the holding period for long-term capital gains?***

**A21.** In order to qualify for long-term capital gains treatment, property must be held for more than 12 months.

**Q22.** ***What are the basic long-term capital gains tax rates?***

**A22.** It depends on what tax bracket you fall into. The tax on the sale of assets held for more than 12 months, i.e., long-term capital gains, breaks down as follows:

0% for those in the two lowest tax brackets
15% for those in the next four tax brackets (the vast majority of people), and
20% for those in the highest tax bracket

**Q23.** ***Are there any changes to depreciation recapture rules?***

**A23.** No. Generally, when selling investment real property, a tax is imposed on all amounts previously taken as depreciation.

The final bill of the Tax Cuts and Jobs Acts retains the current-law rate of 25% on recapture of depreciation on sale of real property.

Q24.***Can I still take advantage of an IRC 1031 ("like kind" tax-deferred) exchange?***

**A24.** Yes for real property exchanges only. The tax-free exchange of "like-kind" real property used in a trade or business is not affected by the most recent Tax Cuts and Jobs Acts.

However, this law eliminated tax free exchanges for personal property.

## IV. Health Care Net Investment Tax

**Q25.** ***Are Capital Gains subject to any other tax?***

**A25.** In January 2013, provisions of the Patient Protection and Affordable Care Act created a 3.8% Medicare tax on unearned income for high-income households with adjusted gross incomes of $200,000 or more for individuals or $250,000 or more for married couples.

The tax does not impact the capital gains exclusion for principal residences ($250,000 for individuals/$500,000 for married couples). The 3.8% tax only applies to taxable gains above this exclusion.

**Q26.** ***What is "unearned" net investment income?***

**A26.** Unearned income is the income that an individual derives from investing his/her capital. It includes capital gains, rents, dividends and interest income. It also comes from some investments in active businesses if the investor is not an active participant in the business.

The portion of unearned income that is subject both to income tax and the new Medicare tax is the amount of income derived from these sources, reduced by any expenses associated with earning that income. (Hence the term "net" investment income.) Thus, in the case of rents, the taxable amount would be gross rents minus all expenses (including depreciation) incurred in operating the rental property. So if gross rents were $100,000 with associated expenses of $40,000, net rents of $60,000 ($100,000 minus $40,000) would be included in Adjusted Gross Income (AGI).

**Q27.** ***Who is subject to the taxes imposed in the health legislation?***

**A27.** A new 3.8% tax will apply to the "unearned" income of "High Income" taxpayers. Another 0.9% tax will apply to the "earned" income of many of these same individuals. Both levies are referred to as "Medicare" taxes.

**Q28.** ***Who is a "High Income" Taxpayer?***

**A28.** Those whose tax filing status is "single" will be subject to the new unearned income taxes if they have Adjusted Gross Income (AGI) of more than $200,000. Married couples filing a joint return with AGI of more than $250,000 will also be subject to the new tax. (The AGI threshold for married filing separate returns is $125,000.)

**Q29.** ***What are the most significant law affecting taxation passed in the last 20 years?***

**A29.** In addition to TCJA, there are myriad laws which have accumulated over the years affecting tax. These include: The Taxpayer Relief Act of 1997 (the "1997 Act") and the IRS Restructuring and Reform Act of 1998 (the "1998 Act") which provides for an exclusion from income for certain amounts of gain from the sale of a principal residence. The Mortgage Forgiveness Debt Relief Act of 2007 (the "2007 Act") provides clarification regarding certain capital gains issues as well.

The Jobs and Growth Tax Relief Reconciliation Act of 2003 (the "2003 Act") also made important changes to the federal taxation laws including, among other matters, lower capital gains tax rates, acceleration of a reduction in tax rates, increased child tax credits and a reduction in the so-called marriage penalty. Sunset provisions in the 2003 Act were extended by the Tax Increase Prevention and Reconciliation Act of 2005, Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 and the American Tax Payer Relief Act of 2012.

With passage of H.R. 3221, the Housing and Economic Recovery Act of 2008, further changes were made to capital gains exclusions for a principal residence that wasn't used as a principal residence part of the time of ownership.

The Patient Protection and Affordable Care Act had an impact on capital gains tax for high income taxpayers.

**Q30. *Where can I obtain additional information?***

**A30.** This legal article is just one of the many legal publications and services offered by C.A.R. to its members. For a complete listing of C.A.R.'s legal products and services, please visit car.org.

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The information contained herein is believed accurate as of February 8, 2018. It is intended to provide general answers to general questions and is not intended as a substitute for individual legal advice. Advice in specific situations may differ depending upon a wide variety of factors. Therefore, readers with specific legal questions should seek the advice of an attorney. Revised by Dana Spears.

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