Principal Residence Gain Exclusion Break

Here's a look at how to apply the $250,000 ($500,000, if married) principal residence tax break when getting married or divorced, or when converting another property into your home.

In both marriage and divorce situations, a home sale often occurs. Of course, the principal residence gain exclusion break can come in very handy when an appreciated home is put on the block.

Sale during Marriage

Say a couple gets married. They each own separate residences from their single days. After the marriage, the pair files jointly. In this scenario, it is possible for each spouse to individually pass the ownership and use tests for their respective residences. Each spouse can then take advantage of a separate $250,000 exclusion.

Sale before Divorce

Say a soon-to-be-divorced couple sells their principal residence. Assume they still are legally married as of the end of the year of sale because their divorce is not yet final. In this scenario, the divorcing couple can shelter up to $500,000 of home sale profit in two different ways:

1. **Joint return.** The couple could file a joint Form 1040 for the year of sale. Assuming they meet the timing requirements, they can claim the $500,000 joint-filer exclusion.
2. **Separate returns.** Alternatively, the couple could file separate returns for the year of sale, using married-filing-separately status. Assuming the home is owned jointly or as community property, each spouse can then exclude up to $250,000 of his or her share of the gain.

To qualify for two separate $250,000 exclusions, each spouse must have

- owned his or her part of the property for at least two years during the five-year period ending on the sale date, and
- used the home as his or her principal residence for at least two years during that five-year period.

Sale in Year of Divorce or Later

When a couple is divorced as of the end of the year in which their principal residence is sold, they are considered divorced for that entire year. Therefore, they will be unable to file jointly for the year of sale. The same is true, of course, when the sale occurs after the year of divorce.

Key point. Under the preceding rules, both ex-spouses will typically qualify for separate $250,000 gain exclusions when the home is sold soon after the divorce. But when the property remains unsold for some time, the ex-spouse who no longer resides there will eventually fail the two-out-of-five-years use test and become ineligible for the gain exclusion privilege.

Let’s see how we can avoid that unpleasant outcome.

When the Non-Resident Ex Continues to Own the Home for Years after Divorce

Sometimes ex-spouses will continue to co-own the former marital abode for a lengthy period after the divorce. Of course, only one ex-spouse will continue to live in the home. After three years of being out of the house, the non-resident ex will fail the two-out-of-five-years use test. That means when the home is finally sold, the non-resident ex’s share of the gain will be fully taxable.

But with some advance planning, you can prevent this undesirable outcome.

If you will be the non-resident ex, your divorce papers should stipulate that as a condition of the divorce agreement,

- your ex-spouse is allowed to continue to occupy the home for as long as he or she wants, or
- until the kids reach a certain age, or
- for a specified number of years, or
- for whatever time period you and your soon-to-be ex can agree on.

At that point, either the home can be put up for sale, with the proceeds split per the divorce agreement, or one ex can buy out the other’s share for current fair market value.

This arrangement allows you, as the non-resident ex, to receive “credit” for your ex’s continued use of the property as a principal residence. So, when the home is finally sold, you should pass the two-out-of-five-years use test and thereby qualify for the $250,000 gain exclusion privilege.

The same strategy works when you wind up with complete ownership of the home after the divorce, but your ex continues to live there. Stipulating as a condition of the divorce that your ex is allowed to continue to live in the home ensures that you, as the non-resident ex, will qualify for the $250,000 gain exclusion when the home is eventually sold.

Little-Known Non-Excludable Gain Rule Can Mean Unexpectedly Higher Taxes on a Property Converted into Your Principal Residence

Once upon a time, you could convert a rental property or vacation home into your principal residence, occupy it for at least two years, sell it, and take full advantage of the home sale gain exclusion privilege of $250,000 for unmarried individuals or $500,000 for married, joint-filing couples. Those were the good old days!

Unfortunately, legislation enacted back in 2008 included an unfavorable provision for personal residence sales that occur after that year. The provision can make a portion of your gain from selling an affected residence ineligible for the gain exclusion privilege.

Let's call the amount of gain that is made ineligible the *non-excludable gain*. The non-excludable gain amount is calculated as follows.

Step 1. Take the total gain, and subtract any gain from depreciation deductions claimed against the property for periods after May 6, 1997. Include the gain from depreciation (so-called unrecaptured Section 1250 gain) in your taxable income. Carry the remaining gain to Step 3.

Step 2. Calculate the non-excludable gain fraction.

The *numerator* of the fraction is the amount of time *after 2008* during which the property is *not* used as your principal residence. These times are called *periods of non-qualified use*.

But periods of non-qualified use don't include temporary absences that aggregate two years or less due to changes of employment, health conditions, or other circumstances specified in IRS guidance.

Periods of non-qualified use also don't include times when the property is not used as your principal residence, if those times are

- after the last day of use as your principal residence, and
- within the five-year period ending on the sale date.

The *denominator* of the fraction is your total ownership period for the property.

Step 3. Calculate the non-excludable gain by multiplying the gain from Step 1 by the non-excludable gain fraction from Step 2.

Step 4. Report on Schedule D of Form 1040 the non-excludable gain calculated in Step 3. Also report any Step 1 unrecaptured Section 1250 gain from depreciation for periods after May 6, 1997. The remaining gain is eligible for the gain exclusion privilege, assuming you meet the timing requirements.

The Basics of Depreciation

Are you thinking about buying personal property (such as a car, a computer, or other equipment) or real property (such as a building)? If you use the property for personal purposes, it's not deductible.

But if you use it in a business, you can deduct the full cost using regular depreciation, bonus depreciation, or IRC Section 179 expensing.

Regular depreciation takes three to 39 years depending on the property involved, while bonus depreciation allows you to deduct 100 percent of the cost of personal property in one year through 2022. Up to $1,050,000 of personal property may also be deducted in one year under IRC Section 179.

But depreciation won't begin if you purchase property with the intent of beginning a new business. You must actually be in business to claim depreciation. This doesn't require that you make sales or earn profits—only that your business is a going concern.

Also, depreciation doesn't begin the moment you purchase property for your business. It begins only when you place property in service in your business. You don't have to use the property to place it in service, but the property must be available for use in your active business. This could occur after you purchase the property.

Finally, if you use regular depreciation, you must apply rules called *conventions* to determine the month in which your depreciation deduction begins. The earlier in the year, the larger your deduction for the first year.

The default rule is that regular depreciation for personal property begins July 1 the first year (mid-year convention). But if you purchase 40 percent or more of your total personal property for the year during the fourth quarter, your depreciation begins at the midpoint of the quarter in which it is placed in service (mid-quarter convention).

First-year depreciation for real property begins at the middle of the month during which the property is placed in service (mid-month convention).