Salvage a partial home-sale gain exclusion

In the tax world, half a loaf, or at least part of a loaf, is usually better than no loaf at all. This principle applies if you're selling your principal residence, but you don't qualify for the generous home-sale gain exclusion.

Strategy: When allowed, claim a "partial" home-sale gain exclusion on your return. In some cases, the partial exclusion will be more than enough to make the gain on the sale of your home federal-income-tax-free.

This tax break is even more valuable this year due to higher taxes for high-income homeowners *(see box below).*

Here's the whole story: If you've owned and used a home as your principal residence for at least two out of the previous five years, you can elect to exclude from tax the first $250,000 of gain realized from selling the home; $500,000 if you file jointly. The exclusion isn't available if you've claimed the exclusion for an earlier sale within the last two years.

However, if you sell the home without meeting the ownership and use requirements—or you've taken advantage of the exclusion within the last two years—you still may be eligible for a partial exclusion. To qualify, the sale must have resulted from a change in employment, a need for medical care, or other IRS-approved unforeseen circumstances.

Unforeseen but not heard

So what are "unforeseen circumstances" for this purpose? The IRS has established the following safe-harbors:

- Death
- Divorce
- Loss of employment
- A job change that reduces your ability to pay for the home
- Multiple births from the same pregnancy
- Damage from a disaster
- Taking of property (e.g., by condemnation).

If none of these safe-harbors apply, the IRS will examine the facts and circumstances of the case. The critical factors are whether the home has become less suitable as a principal residence, if your ability to pay for the home has materially decreased, and if the reason for the sale could have been reasonably anticipated when you acquired the home.

To figure out the amount available in a partial exclusion, multiply the available exclusion amount (maximum of $250,000 or $300,000) by the appropriate ratio.

Example: You and your spouse have lived in and owned your home as your principal residence for nine months instead of the normally required two years. Due to unforeseen circumstances, you're forced to sell the home at a $200,000 gain before meeting the two-year requirement.

On these facts, you can exclude up to $187,500 from tax on the home sale . The remaining $12,500 gain ($200,000 – $187,500) is taxable as a long-term capital gain *(see box).*

Online resource: Use the worksheet in IRS Pub. 523, Selling Your Home to calculate a partial home-sale exclusion.

Feel the pain on taxable gain

If you can't exclude the entire gain from a home sale, the remaining gain is taxed at capital gain rates. The maximum tax rate on long-term capital gain for upper-income homeowners increases from 15% to 25% in 2013, while the top rate on short-term gains rises from 35% to 39.6%. Also, you may owe the 3.8% Medicare surtax on the gain that doesn't qualify for the exclusion.

Example: You're in the top 39.6% tax bracket for ordinary income, you must pay the 20% rate on long-term capital gains and the 3.8% surtax applies to your investment income. Now you're forced to sell your home due to unforeseen circumstances. Although you qualify for a partial exclusion, your remaining taxable gain is $100,000.

Result: If you've owned the home for a year or less, your tax is $43,400 (43.4% of $100,000). Even if your gain qualifies as long-term gain, you still owe $23,800 in tax (23.8% of $100,000).

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