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Why bypass the home sale exclusion?

Sometimes it makes sense to pass up a current tax break for something better later on.

Strategy: Don't claim the home sale exclusion now if you can shelter more profit from tax in a subsequent home sale. As long as you meet the tax law requirements (*see box below*), you can save the exclusion for the time it will do you the most tax good.

This technique may be especially beneficial if you're realizing a relatively small gain on an earlier sale and expect a bigger gain on a later sale.

Here's the whole story: You can exclude from taxable income up to $250,000 of gain from the sale of a principal residence; $500,000 if you're married and file a joint return. To qualify for this lucrative tax break, you must have owned and used the home as your principal residence for at least two of the five years preceding the sale.

Alternatively, if you fail either the use or ownership tests, you still may qualify for a partial exclusion if you're forced to sell the home due to a change in employment, health reasons or certain other unforeseen circumstances.

This is not a one-time opportunity. You can take advantage of the exclusion multiple times during your lifetime. But it can't be used if you've claimed the exclusion for another home within the past two years. If you're fortunate enough to own two homes, you might bypass the home sale exclusion for a chance at a bigger tax savings down the road.

Example: You and your spouse moved into a condo five years ago that cost $600,000. It was your principal residence for the first three years of ownership.

But you also own a lakehouse in a resort area you bought years ago at the bargain price of $200,000. For the last two years, you've lived mostly at the lakehouse, so it also qualifies as your principal residence.

Earlier this year, you were able to sell the condo. You're also planning to sell the lakehouse and move permanently to a warmer climate. The real estate market is strong in the resort area, so you figure the lakehouse will fetch around $700,000 in a sale. You are in the maximum 20% tax bracket for long-term capital gains.

On these facts, you're entitled to the home sale exclusion for the condo sold earlier in 2018. If you claim the exclusion for this sale, you won't have to pay tax on a $25,000 gain. With the maximum 20% long-term capital gains rate, you'd save $5,000 (20% of $25,000).

Better approach: Don't claim the home sale exclusion for the condo. Instead, pay the tax bill at the long-term capital gains rate. Then, if you sell the lakehouse for $700,000 later this year, you can claim the maximum $500,000 home sale exclusion. This saves you $100,000 in capital gains tax (20% of $500,000), compared to just $5,000 if you use the gain exclusion privilege to shelter the gain from the earlier sale.

Tip: The two years of ownership and use don't have to be consecutive.

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Here are some of the special rules relating to the home sale exclusion:

Joint filers: If you file jointly, you may claim the maximum $500,000 gain exclusion if (1) either spouse meets the two-year ownership test, (2) both spouses meet the two-year use test and (3) neither spouse has claimed the exclusion within the last two years.

Use test: You must physically occupy the home for at least two years. But short temporary absences won't count against you.

Principal residence test: If you own and reside in two homes during the year, the place where you stay most of the time is your principal residence.

Depreciation recapture: If you've claimed depreciation on a home office, you must recapture any gain attributable to the depreciation deductions for business use of the office space after May 6, 1997, at a maximum 25% rate.

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