How Capital Gains from the Sale of a Home Are Taxed

For most of us, our home represents our largest asset. Over time, the management of this asset can make a big difference in our overall financial outlook. One of the largest planning opportunities home ownership brings is the favorable tax treatment afforded the sale of a primary residence.

The gain on the sale of a home is considered a gain on the sale of a capital asset. Any taxable profit you make is subject to a maximum long-term capital gain rate of 15% (down to 5% for taxpayers in the 10-15% federal income tax bracket) if you owned the house for more than 12 months. Gain on the sale of a home may be taxable only if they exceed $250,000 for single filers ($500,000 for joint filers) if certain conditions discussed below are met.

Determining Your Net Gain

To determine your profit (gain), you subtract your basis from the sale price minus all costs and commissions. For instance, if you sell a house for $250,000, and must pay your broker 6% of the sale price -- or $15,000 -- your sale price for determining capital gain tax is $235,000 ($250,000 minus $15,000).

Say you bought that house 20 years ago for $35,000. You have since redone the kitchen and bathrooms, put in new windows, added a bedroom, and a new roof. Your basis in the house is $35,000 plus the cost of all of the capital improvements you have made, providing you have documentation verifying the costs. Let's assume the total cost of those improvements over the 20 years you owned the home is $40,000. In such a case, your basis would be $75,000. Your capital gain would be $235,000 minus $75,000, or $160,000. If you are in the 28% federal tax bracket or higher, your capital gain tax on your home sale would be $24,000 unless you use the principal residence exclusion.

The Primary Residence Exclusion

Here's where the favorable tax treatment of capital gains from a residence come in. A $250,000 exclusion for single filers ($500,000 for joint filers) is now available to all taxpayers. You can claim the exclusion once every two years. To be eligible, you must have owned the residence and occupied it as a principal residence for at least two of the five years prior to the sale or exchange. If you fail to meet these requirements due to health reasons, a change in place of employment, or other unforeseen circumstances, you can exclude the fraction of the $250,000 ($500,000 if married filing a joint return) equal to the fraction of two years that these requirements are met. For example, let's say you were forced to move for employment reasons after only living in a home for 12 months. Without the qualified exclusion, your full tax would have been $20,000. Instead, you would pay just half, since you lived in the home 12 of the 24 months required, or 0.5 of the period. The tax of $20,000 multiplied by 0.5 would yield a tax bill of just $10,000.

For many Americans at or nearing retirement age, their home represents a terrific opportunity to "cash out," pad their retirement portfolio with tax-free gains, and help ensure their "golden years" truly live up to the name. Feel free to ask us for guidance in making this important decision.

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