FINANCIAL EXPERTS NETWORK

Tax Planning When Client Has Large Gain on Sale of Home

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Today’s Presenter

- Lawrence Pon
  - Lawrence Pon is a Certified Public Accountant, Personal Financial Specialist, Certified Financial Planner, Enrolled Agent, United States Tax Court Practitioner, and Accredited Estate Planner in Redwood Shores, CA
  - Mr. Pon has been in practice since 1986 and speaks regularly to tax professionals and financial planners on the latest tax planning and preparation topics nationally.
  - Mr. Pon received his BS in Business Administration from UC Berkeley and MS in Taxation from Golden Gate University in San Francisco

Tax Aspects of Selling a Home

- How Do I Calculate the Profit from the sale of my home?
- How Do I calculate the tax on the sale of my home?
- What can I do to reduce the tax bill?

Formula

- Sales Price
  - Less:
    - Cost basis
    - Exclusion
- Taxable Gain

Capital Gains Tax

2026 Long-term Capital Gains Rates

Filing Status	0% Tax Rate	15% Tax Rate	20% Tax Rate
Single	< $49,450	$49,451 to $545,500	>$545,500
Married filing jointly	< $98,900	$98,901 to $613,700	>$613,700
Married filing separately	<$49,450	$49,451 to $306,850	>$306,850
Head of household	< $66,200	$66,200 to $579,600	>$579,600

Ordinary Tax Rates

2026 tax brackets

Tax rate	Single filers	Married couples filing jointly	Married couples filing separately	Head of household
10%	$12,400 or less	$24,800 or less	$12,400 or less	$17,700 or less
12%	$12,401 to $50,400	$24,801 to $100,800	$12,401 to $50,400	$17,701 to $67,450
22%	$50,401 to $105,700	$100,801 to $211,400	$50,401 to $105,700	$67,451 to $105,700
24%	$105,701 to $201,775	$211,401 to $403,550	$105,701 to $201,775	$105,701 to $201,750
32%	$201,776 to $256,225	$403,551 to $512,450	$201,776 to $256,225	$201,751 to $256,200
35%	$256,226 to $640,600	$512,451 to $768,700	$256,226 to $384,350	$256,201 to $640,600
37%	Over $640,600	Over $768,700	Over $384,350	Over $640,600

Source: Internal Revenue Service

Reporting the Sale

- Form 1099-S – Proceeds from Real Estate Transactions
- Schedule D (Form 1040) – Capital Gains and Losses
- Form 8949 – Sales and Other Dispositions of Capital Assets

Reporting the Sale

- Closing Statement
  - Sales Price
  - Personal Property
  - Selling Costs
    - Commissions
      - Buyer’s Agent
      - Seller’s Agent
    - Transfer taxes
    - Escrow fees
    - City/town taxes
    - County taxes
    - Assessments

Closing Statement

- Additional Settlement Charges
  - Survey
  - Pest Inspection
  - Pest Repairs
  - Septic Inspection
  - Septic Repairs
  - Property Inspection
  - Termite Inspection
  - Chemical Treatment
  - Title charges
  - Settlement closing fee

Closing Statement

- Amount Paid on Behalf of Seller
  - Staging
  - Repairs
- Reductions in Amount Due to Seller
  - Payoff of mortgages
    - Interest
    - Charges
  - County/city/town taxes
  - Assessments
- Amount due to seller

Qualifying for the Exclusion

- Section 121 Exclusion
  - Ownership Test
  - Use Test
- Owned AND Used home for a period aggregating at least two years out of the five years prior to its date of sale.
- You can meet the ownership and use tests during different 2-year periods.
- Must meet both tests during the 5-year period ending on the date of the sale

Qualifying for the Exclusion

- NOT eligible for the exclusion if you excluded the gain from the sale of another home during the two-year period prior to the sale of your home.

Suspension of 5-year Test Period

- Qualified official extended duty in the:
  - Uniformed Services
  - Foreign Service
  - Intelligence community
- Elect to suspend the 5-year test period for up to 10 years
- Qualified official extended duty
  - If for more than 90 days or for an indefinite period
    - At a duty station that’s at least 50 miles for main home, or
    - Residing under government orders in government housing

Installment Sales

- Part or all of selling price to be paid in later year,
  - Report sale under installment method unless elect out
  - Section 121 exclusion remains available

Section 121 Exclusion

- Exclude
  - $250,000 of capital gains on sale of home if you are single
  - $500,000 of capital gains on sale of home if you are married filing jointly
- Not qualify
  - House was not your principal residence
  - Owned home less than two years
  - Did not live in house for at least two years in the five-year period
  - You already claimed the exclusion in less than 2 years
  - You bought the house through a 1031 like-kind exchange in the past 5 years
  - You are subject to the expatriate tax

Section 121 Exclusion

- How to qualify
  - Live in house for at least 2 years
  - Principal residence – main home
    - More than one home?
      - Facts & circumstances
  - If less than 2 years, do you qualify for an exception?
    - Work
    - Health
    - Unforeseeable event

Section 121 Exclusion

- Types of real estate
  - Single family home
  - Condominium
  - Townhouse
  - Cooperative apartment
  - Mobile home
  - Houseboat

Partial Exclusion

- Work-related move
  - Transferred to a new job at least 50 miles farther from home
  - Needs to apply to only one spouse
- Health-related move
  - Moved to obtain, provide, or facilitate diagnosis, cure, mitigation, or treatment of disease, illness, or injury to yourself or family member
    - Family includes
      - Parent, grandparent, child, brother, sister, In-laws, uncle, aunt, nephew, niece
  - Doctor recommended change in residence

Partial Exclusion

- Unforeseeable Events
  - Home destroyed or condemned
  - Home suffered a casualty loss
    - Natural or man-made disaster
    - Act of terrorism
      - No matter if loss is deductible or not.
  - You, your spouse, co-owner, or anyone else for whom house is residence
    - Died
    - Became divorced or legally separated
    - Gave birth to two or more children from same pregnancy
    - Became eligible for unemployment compensation
    - Became unable to pay basic living expenses

Partial Exclusion

- Other Facts and Circumstances
  - The situation causing the sale arose during the time you owned and used your property as your residence
  - You sold your home not long after the situation arose
  - You could not have reasonable anticipated the situation when you bought your home
  - You begin to experience significant financial difficulty maintaining the home
  - The home became significantly less suitable as a main home for you and your family for a specific reason

Divorce

- Transfer home to a spouse or ex-spouse
  - Divorce settlement
    - No gain or loss
    - Nothing to report
  - If spouse or ex-spouse is a nonresident alien
    - Gain or loss from the transfer

Example

- Sale Price = $1,500,000
  - Closing date = June 19, 2026
- Purchase price = $1,000,000
- Closing costs = $105,000
- Purchase date = June 1, 2020
  - Gain = $395,000
    - Fully excluded
- Purchase date = June 19, 2024
  - Partial exclusion = 12/24 = 50% X $500,000 = $250,000
  - Taxable gain = $395,000-$250,000 = $145,000

Calculate Cost Basis of Home

- Purchase price plus closing costs
- Refinance Costs
- Improvements

Basis

- Fees and Closing Costs
  - See closing statement on purchase closing statement
    - Abstract fees
    - Utility hook up fees
    - Legal fees
      - Title search
    - Recording fees
    - Survey fees
    - Transfer or stamp taxes
    - Owner’s Title Insurance

Basis

- Settlement Fees and Closing Costs That Are NOT included in basis
  - Fire insurance premiums
  - Rent for occupancy of the house before closing
  - Charges for utilities
  - Mortgage insurance premiums
  - Mortgage interest
  - Real estate taxes
  - Homeowner Association dues

Basis

- Construction
  - Cost of land
  - Cost of labor and materials
    - Do not include your own labor
    - Do not include labor for which you did not pay
  - Architect’s fees
  - Building permit charges
  - Utility meter and connection charges
  - Legal fees directly connected with building the house

Basis

- Improvements
  - Additions
    - Bedroom
    - Bathroom
    - Deck
    - Patio
  - Lawn & Grounds
    - Landscaping
    - Driveway
    - Fence
    - Retaining wall
    - Swimming Pool

Basis

- Improvements
  - Exterior
    - Windows/doors
    - Roof
    - Siding
  - Insulation
  - Systems
    - HVAC
    - Central vacuum
    - Security system
    - Wiring

Basis

- Improvements
  - Plumbing
    - Septic system
    - Water heater
    - Filtration system
  - Interior
    - Built-in appliances
    - Kitchen remodel
    - Flooring
    - Wall to wall carpeting
    - Fireplace

Basis

- NOT improvements
  - Repairs and maintenance
    - Painting
      - Exterior & interior
    - Fixing leaks
    - Filling holes & cracks
    - Replacing broken hardware
  - Improvements that are no longer part of your home
    - Old wall to wall carpets
  - Life expectancy of less than 1 year
  - If claimed solar energy credits on solar panels

Renovate Before Selling?

- Many buyers want a home in move-in condition
- Compete with new construction
- First impressions
- Hot markets
  - No inventory
  - Bidding wars
- Buyers will renovate anyway

Renovate Before Selling?

- Update things that pay you back
  - Remodeling Magazine Cost vs. Value Report
    - Improve home’s curb appeal provide most return on investment
      - Garage door replacement – recoup 94% of cost
      - Stone veneer on the exterior – recoup 92% of cost
      - Kitchen remodel – 72% return
- Get a home inspection
- Pay at closing

Spouse Passed Away

- Community property
  - Full step up in basis
  - Add improvements since date of death
- Non-community property
  - Step up for deceased spouse share only
  - Add improvements since date of death

Home Office & Former Rental

- Capital gain on depreciation
  - Recapture
- Former rental property or vacation home
  - Can I use exemption?
    - Maybe not
    - Complicated set of rules
      - Disqualified use rules

Former Rental

- Capital gains exclusion is specifically available only for periods which the property was actually used as a primary residence
  - Since January 1, 2009, property was not used as a primary residence is deemed "nonqualifying use"
    - Gains not eligible for exclusion
  - Example
    - Rented out property for 4 years and then used as a primary residence for two years
    - Gain = $150,000
      - Allocate between qualifying use and non-qualifying use
        - 2/6 = qualifying use = $50,000 deemed qualifying
        - $100,000 nonqualifying use subject to capital gains

Second Homes & Vacation Homes

- Not principal residence
  - No Section 121 exclusion
- Capital gain
- No capital loss
- Depreciation recapture on vacation homes

What If I have a Large Gain?

- Make sure you have everything included in cost basis
- Consider utilizing Section 1031 exchange
- Consider utilizing QOZ Funds
- Consider charitable giving strategies

Sale of Home with §1031

- House is worth $2 million
- Cost basis is $500,000
  - If home is sold capital gain would be $1,000,000
  - Rent out home for less than three years
  - Sell home for $2 million within 3 years of when it was converted to rental
  - Purchase new home for $1,500,000 in a §1031 exchange
    - Rent out new home to qualify for §1031 exchange
    - Pocket $500,000 with no capital gain
    - Eventually move into new home within 2 years and keep the same property tax assessment from the original property.

Sale of Home with §1031

- Apply sale-of-home rules before like-kind exchange rules
  - §121 exclusion must be applied to the gain from the exchange before the application of §1031
- Depreciation recapture
  - §121 exclusion does not apply to depreciation deductions after May 6, 1997
- Treatment of boot
  - Taxable if it exceeds §121 exclusion
- Computation of basis
  - Basis in replacement business property is increased by any gain attributable to the relinquished business property that is excluded under §121

Sale of Home with §1031

- Example
  - Home cost = $210,000
    - Rented out for 2 years and claims depreciation deduction of $12,000
    - Exchanges house
      - FMV = $470,000
        - $10,000 cash
        - Townhouse = $460,000 – rent to tenants
      - Gain realized = $272,000

Sale of Home with §1031

- Amount realized = $470,000
- Less adjusted basis ($210,000 - $12,000)
  - $198,000
  - Realized Gain = $272,000   (470,000-198,000)
  - Less gain excluded under §121 = $250,000
  - Gain to be deferred under §1031 = $22,000
  - No gain recognized because the $10,000 boot is less than $250,000 exclusion.

Sale of Home with §1031

- No §121 exclusion for property exchanged in the last five years
  - This applies even if the home is received as a gift if the donor acquired the property in a like-kind exchange.

Qualified Opportunity Zones (old)

- Defer all or a portion of gain
- Permanent exclusion of some gain in investment held for at least 5 years
- Permanent exclusion of all zone gain if held for at least 10 years
- Gains must be reinvested within 180 days of sale
- Gain is recognized on earlier of:
  - Date investment is sold; or
  - December 31, 2026

Qualified Opportunity Zones (old)

- Basis starts at zero
  - Add gain recognized on 2026 return
  - Increase by 10% if held for 5 years (12/31/21)
  - Add another 5% if held for 7 years (12/31/19)
  - After 10 years basis is FMV
  - Invest by 12/31/19 for full benefit

Qualified Opportunity Zones

- QOZ vs. 1031
  - Most capital gains qualify
    - Not only from real estate
    - Short term or long-term capital gains
  - Can invest in gains only
    - Only gain portion of proceeds
    - Not entire principal
  - Identification period
    - None for QOZ

Qualified Opportunity Zones

- QOZ vs. 1031
  - Location of replacement property
    - QOZ property have to be in approved zones
  - Availability
    - 1031 – available indefinitely
    - QOZ – Extended by OBBBA
  - Estate planning
    - QOZ - not eligible for step-up in basis
    - 1031 – step up in basis

Qualified Opportunity Zones

- QOZ properties?
  - Additional risk?
  - Operators?
    - Experience level
    - Costs
  - Cash flow

Charitable Giving

- Donate portion of home to charity
- Donate portion of home to Charitable Remainder Trust
- Donate portion of home to Charitable Gift Annuity
- Donate portion of sales proceeds to Charitable Gift Annuity

Donate to Charity

- Will the charity accept real estate
- Charity will be seller of real estate
- Mortgage?
- Gain goes to charity
- Deduction for donation of home
  - Appraisal at time of gift
  - Form 8283

Charitable Remainder Trust

- Charitable Intent is Key
- Charitable Deduction
- Income for rest of life
- Remainder goes to charity

Charitable Gift Annuity

- Will the charity accept real estate?
- Less complicated than CRT
  - No Form 5227
  - No investment responsibilities
- Less flexibility than CRT

Gifting Proceeds to CGA

- Walking around money
- Tax deduction to reduce tax
- Predictable cash-flow

Single Life Suggested Maximum Gift Annuity Rates

Age	Rate
5-11	3.8
12-24	3.9
25-31	4.0
32-37	4.1
38-41	4.2
42-44	4.3
45-47	4.4
48-49	4.5
50-52	4.6
53	4.7
54-55	4.8
56-57	4.9
58	5.0
59	5.1
60	5.2
61	5.3
62-63	5.4
64	5.6
65	5.7
66	5.8
67	5.9
68	6.1

Age	Rate
69	6.2
70	6.3
71	6.4
72	6.6
73	6.7
74	6.8
75	7.0
76	7.2
77	7.4
78	7.6
79	7.8
80	8.1
81	8.3
82	8.5
83	8.7
84	8.9
85	9.1
86	9.3
87	9.5
88	9.7
89	9.9
90+	10.1

Conclusion

- Tax planning needs to be done before the sale of a home
- Client has to keep track of all improvements
- Client needs to let us know their plans and goals in advance

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