## You Made A Profit, You Will Have To Pay The Tax

**Question:** I plan to sell my house this fall. I am unmarried and have lived in my house as my principal residence for many years. I believe that I will "realize" $500,000 from the sale. I understand that I can shelter $250,000 by taking the exemption. Can I "roll-over" the remaining $250,000 by purchasing a new principal residence of equal or greater price? I have heard that section 1034 of the Internal Revenue Code would permit that. Am I correct?

**Answer:** No. Section 1034 of the Tax Code was repealed several years ago when Congress enacted and President Clinton signed into law the Taxpayer Relief Act of 1997. Prior to 1997, if within two years before or after you sold your existing home you purchased a new principal residence -- and the purchase price of the new property was equal to or greater than the sales price of the older home -- you were able to defer any capital gains tax, because the profit you made on the sale of your house was rolled over into the purchase price of the new property. This was known as the "roll-over."

Note that I used the word "defer." Ultimately, when you sold your last house, there were taxable consequences.

Today, under the new law, there is no more roll-over. Instead, you can completely exclude up to $250,000 of gain (and up to $500,000 if you are married and file a joint tax return) if you have owned and used the house as your principal residence for two out of a five year period before it is sold.

Your question, however, confused me. What exactly do you mean when you say "you will realize $500,000." Does that mean that you will have made $500,000 in profit, or that the sales price will be this amount?

Let's analyze both scenarios, but first we need to define some basic tax terms:

> *Basis.* This is the initial cost of the property.
> *Adjusted basis.* You add to your basis the cost of any improvements you have made over the years.
> *Gross profit.* This is the difference between your adjusted basis and the sales price.
> *Net profit.* You have to subtract from gross profit any real estate commissions paid when you sold the property, any seller credits given to your purchaser, and certain fix-up costs. The bottom line net profit is also called "capital gain."

*Scenario One -- Sale Price $500,000*

You purchased your house many years ago for $50,000, and made $50,000 of improvements. Your adjusted basis is $100,000. You now sell the house for

$550,000, and after deducing real estate commissions and settlement charges, you will walk away with $500,000.

Thus, your capital gain is $400,000 (500,000 - 100,000).

You are not married, but have owned and lived in the house for two out of the past five years prior to sale.

The tax laws allow you to completely exclude (not defer) $250,000 of the profit you have made when you sold the house. The remaining profit of $150,000 (400,000 - 250,000) will be taxed, and the current federal tax rate is 15 percent. Thus, you will have to pay Uncle Sam approximately $22,500. You will also have to pay the applicable State tax in the jurisdiction where you live.

You cannot roll over this taxable gain into a new principal residence.

*Scenario Two -- Capital Gain $500,000*

Here, instead of selling the house for $550,000, you get lucky and sell it for $650,000. Since all other factors remain the same, in this example you have made a capital gain of $500,000.

Once again, you can exclude up to $250,000 of this gain. You cannot roll-over the balance, but instead will have to pay tax on this profit. At the current federal tax rate, your taxable consequences will be $37,500 (15 percent of $250,000).

As you can see, although Congress in 1997 gave homeowners a considerable tax break, it was not a carte blanche to completely avoid paying any capital gains tax. As a Congressman once told me: "My constituents back home have not had the benefit of the phenomenal real estate increases as we have here in Washington. I have made a lot of money on my house, and I will have to pay my fair share of my capital gains tax."

There is one way to defer the balance of the capital gains tax, but I do not believe it is applicable to your situation.

Let us assume that you have a legal, rental apartment in your home. For many years, you have carefully documented this investment, by reporting to the IRS the income each year, and depreciating the portion of your house which has been used for investment purposes.

In this situation, it is possible to combine the principal residence exclusion with a like-kind "Starker" exchange.

How does this work? Let's take another example. For many years, one quarter of your house has properly and officially been used for investment (rental)

purposes. You sell the property for $500,000. Three quarters of this can be claimed as a principal residence, and you can take your percentage of the $250,000 based on this portion of the property.

However, since you have carefully documented that one fourth of your house has been investment property, you can exchange it for another property whose cost is at least $125,000 (i.e. 25 percent of $500,000). There are strict rules regarding such a Section 1031 (Starker) exchange, and you must talk with your tax advisors about this before you even consider selling your house.

There is one important point which every homeowner should know. Be careful when you calculate your basis. Let's look at scenario one again, but with one additional fact. Before you purchased your present house, you owned another one. You bought that for $25,000 and sold it for $50,000. Because it was before 1997, you were able to roll over your $25,000 profit into the house that you currently own. (For this discussion, I am ignoring costs and improvements.) Although you paid $50,000 for the current house, in fact the roll-over caused your basis to drop down to $25,000 (50,000 - 25,000). Thus, in our example, your capital gain is increased by $25,000, and you will have to pay $3,750 more in federal income tax (15 percent of $25,000).

This is something which everyone who took advantage of the roll-over should know and should plug these numbers into your calculations of gain.

The bottom line however: You have made a lot of money on your investment. You will have to pay your fair share of the capital gains tax.