Key Wealth

Key Wealth Institute

Capital Gains Tax and Home Sales

Bradley Williams, CFP®, ChFC®, Wealth Planner

For many Americans, their primary residence is the most valuable real estate holding on their net worth statement. It is quite often the only asset in the real estate portion of their holistic asset allocation. In recent years, many Americans have experienced significant gains in the value of their homes. This provides a unique situation in which their home has significant equity built up since the time of purchase.

Selling a primary residence in 2024 can be a profitable transaction for Americans. Homes in many states, like Florida, California, and Tennessee, have appreciated more than those in other states. As people begin to sell their homes, they are getting stuck with unexpected tax bills. Capital gains on primary residences are a little different than gains on secondary and commercial properties.

One of the big tax breaks for your home is the home sale exclusion: Single filers can claim an exemption of up to $250,000 of net gains on a sale, and married couples filing jointly receive up to $500,000. To qualify for the exemption, you must follow a few rules. The first is that you must have owned your home and used it as your primary residence for at least 24 months (two years) out of the last five years leading up to the sale. For married couples, each spouse must meet the residence requirement individually, but only one spouse has to satisfy the ownership requirement. If you were ever away from the home, you need to determine whether that time counts towards the residence requirement. The exemption amounts were set by Congress in 1997 and have not been adjusted for inflation. To provide individuals and families with the same tax benefit as it did in 1997, the exemption amount would need to be much higher in today's dollars.

Calculating the gain

The taxable gain is the difference between the selling price and the adjusted basis of the home. If you have lived in your home for quite some time and have kept good receipts for any renovations and capital improvements, then your adjusted basis might be higher than your original purchase price of the home.

For instance, adding a pool for the summertime or upgrading your kitchen would help increase your basis. Routine maintenance and care of the home will not affect basis. If your net sale amount exceeds the $250,000 or $500,000 exemption, then the difference will be subject to capital gains tax on your tax return.

Items that increase basis

IRS Publication 523[1] Selling Your Home contains information on what constitutes an improvement, information on closing statements that should be included in basis, and other information useful for this topic.
Here is a list of items that increase basis (not an all-inclusive list):

- **Fees and closing costs**
- **Additions –** bathrooms, bedrooms, a deck, garage, porch or patio
- **Lawn and grounds –** landscaping, driveways, fences, retaining walls, swimming pools (fixed)
- **Exterior improvements –** windows, new roof, new siding
- **Insulation –** attic, walls, floors, pipes and duct work
- **Systems –** heating, central air conditioning, furnace, wiring, security system, lawn sprinkler system

Note that if you are adding to your basis any energy-related improvements and you received a tax credit or subsidy related to those improvements, you must subtract those credits from your total basis.

Other considerations:

- **Basis step-up at death –** At death, the basis of real estate will get adjusted to fair market value. Effectively, this will eliminate any tax on prior capital appreciation. Sometimes, holding property until death, in order to receive the step-up in basis, may be the right strategy to avoid capital gains tax.
- **Tax Cuts and Jobs Act (TCJA) expiration –** Prior to TCJA, the capital gains tax rates were tied to the ordinary income tax brackets. If the TCJA provisions expire at the end of 2025, the capital gains tax rates will once again be tied to ordinary income tax brackets.
- **Partial exclusion –** You may be able to qualify for an exclusion of gain less than the full amount if the main reason for your home sale was a change in workplace location, a health issue, or an unforeseeable event. IRS Publication 523 Selling Your Home provides more detail on this.
- **Property used partly for business or rental –** There is a special calculation to separate the gain/loss for the business and residence portions of your property. Don’t forget about depreciation recapture for gain attributable to the business or rental portion. For rental property that was converted to personal use as a main home, there is a 5-year holding period requirement in order to meet the use test.
- **Separation or divorce during the ownership of the home –** If the home was transferred to you by a spouse or an ex-spouse (whether in connection with a divorce or not), you can count any time when your spouse owned the home as time when you owned it. However, you must meet the residence requirement on your own.
- **Property acquired through a like-kind exchange –** If property was acquired through a like-kind exchange (1031 exchange) during the past five years, the home sale isn’t eligible for the exclusion.
- **Multiple homes –** If you plan to sell another main home within the next two years and you are likely to receive a larger gain on it, you can do some planning to take the home exclusion on the home with the largest gain. Just remember to report any taxable gain from any home on your tax return, whether it is subject to the home exclusion or not.

Capital Gains Tax and Home Sales

When making the decision to sell your home or stay put, taxes can make the decision even more difficult. Inflation has been a worrisome topic for many as of late, but it could ease some of the tax burden expected on the tax return. Due to higher inflation, overall income tax bracket limits have been shifted higher. If you do run into a situation in which capital gains result from your home sale, the total tax bill should be much more favorable than it was a few years ago due to this increase in income tax brackets. There is an old saying, “Don’t let the tax tail wag the investment dog.” The same can be said for the “housing decision dog.” Many people worry about paying taxes and delay a home sale decision that may enhance their financial situation, lifestyle, or both. The financial planning process provides an opportunity to evaluate and discuss both the qualitative and quantitative aspects of your home sale decision.

I like to remind our clients that taxes are only a portion of the decision when deciding to sell their home and purchase another. Most people move due to life circumstances and to be in a place that provides them more happiness. It is often best to focus on what we are moving to rather than what we are moving from. Focusing on the benefits of finding a new place to call home may help the tax situation not seem as daunting.

For more information, please contact your advisor.

The Key Wealth Institute is a team of highly experienced professionals representing various disciplines within wealth management who are dedicated to delivering timely insights and practical advice. From strategies designed to better manage your wealth, to guidance to help you better understand the world impacting your wealth, Key Wealth Institute provides proactive insights needed to navigate your financial journey.

Key Wealth

[1] IRC Code Section 121.

240625-2659929