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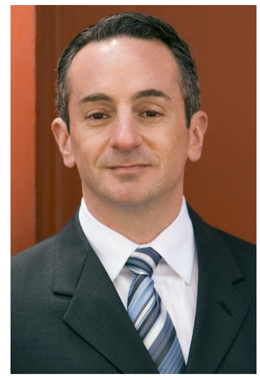

## Personal Residence Tax on Profit: Alive and Well for Reconstructed Houses

*by David Herzog, Associate*

Let's play a game: You can be the taxpayer, and for this game, you get to be a homeowner. I will be the IRS. (So far I'm not enjoying this game, but it may turn around for me.)

You own your home, which you bought in 1984. You paid $150,000. In 1996, you decided that you wanted your house to be larger. However, a mere addition was not feasible because building codes had changed. You demolished your house, including its foundation, and built a new one. You finished building in 1999, and instead of moving back in, you sold it (along with all of the land, of course). The buyer paid you $1,100,000 for it. Nice work! You're happy. OK, you're winning. But the game's not over.

You take your construction invoices and cancelled checks to your CPA, all of which you saved (well done!). Your CPA says that you have a profit on the sale totaling $591,406, the difference between the sale price on the one hand, and your cost (plus improvements) on the other hand. Profit?! How exciting for you!! You are seriously winning.

You file your tax return, and you pay tax on the profit of $91,406 ($591,406 - $500,000), and in your tax return you tell the IRS (me, in this game) that $500,000 is tax free gain. Good for you for knowing and using the rules to win. But I'm the IRS, and I'm feeling lucky.

I (the IRS) decide that you can't use the $500,000 rule to avoid paying tax. Here's my thinking: Profit is taxable, generally speaking. You buy an asset, and if you sell it for more than you paid for it (plus what you paid to improve it), you have a profit, and there's a tax on that profit. (In tax lingo, your cost is your "basis", and your profit is a "capital gain".) However, homeowners of personal residences get a break from the capital gain tax. For married couples, the first $500,000 in gain is tax-free gain, but only if "during the 5-year period ending on the date of the sale or exchange, such property has been owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating 2 years or more." (That's from the Internal Revenue Code, Section 121.) In other words, just live in your house for 2 years within the last 5 years, and you get your tax-free gain (up to $500,000 in gain). BUT, it just strikes me (IRS) as wrong that you are using this rule for what is really a brand new house that you have never lived in.

So, I think I'm right, and you think you're right. We decide to roll the dice and let the tax court decide. And the tax court judge says: "The words 'property' and 'personal residence' mean something you have lived in, a dwelling." He goes on: "My view," says the judge, "is that you have not lived (i.e., dwelt) in this beautiful and costly new home (with a new foundation), even though you lived in the old house."

The judge thinks that the language in Section 121 is ambiguous, so he looks through all sorts of historical documents, opinions, and legislative history; he even looks in some dictionaries so he can pin down what Congress intended - and what is plainly meant - by the words "property" and "principal" and "residence". The judge concludes that Congress intended these words to refer to the old property along with the *old* house, not the shiny new house.

So the judge says you're wrong, and that I (the IRS) am right. What's this?! In addition to what you've already paid me, you owe me an additional $75,000! I think that means I win . . . Right?

You might ask (as did the dissenting judges):
What about couples whose houses were demolished by an uninsured catastrophe who would be trapped by this ruling, or taxpayers in the future who will be stuck trying to figure out if what they are doing is a remodel or reconstruction? To that the judge said the court is not in the business of predicting future cases.

Lesson learned: Reconstructing a house (and, perhaps now, large renovations) resets the two-year requirement for the $500,000 exclusion from tax. Consider this before swinging the wrecking ball.

Adding Insult to Injury: The judge also ruled in this case (Gates v. Commissioner 135 T.C. No. 1 (July 1 2010)) that the taxpayers were late in filing their return, and that they did not have reasonable cause for being late. That's a penalty. How much? If it's late enough, 25% of the tax. Ouch!

I so win. Good game. Thanks for playing!

*This article is intended as a general guideline. The rules are complex, and changing continually. Please consult your tax advisor.*

*If you have any questions or suggestions for article topics, please feel free to email me at dherzog@pinnaclelawgroup.com.*

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