



## Home Improvement

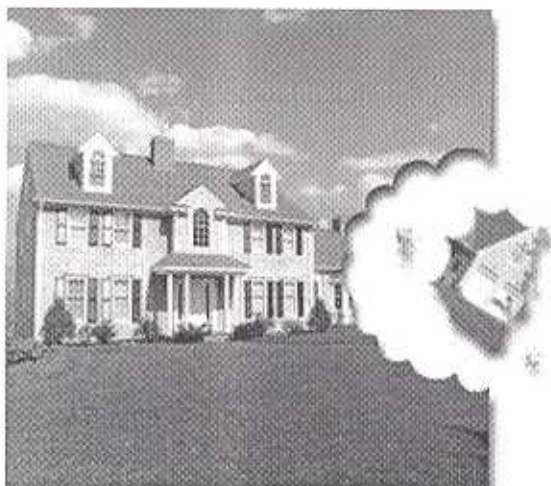
## Real Estate Tax Break--Or Bite?

Betsy Schiffman

Let's suppose you bought a house ten years ago for \$500,000. You're family has grown, and you need a larger home. You decide to sell. Because you renovated your home, and because it's in a desirable neighborhood, you sell it for \$2 million, four times the original price.

It's a nice profit, but it's not all yours. Get ready to pay the IRS about \$300,000--that's 20% of the \$1.5 million you made off the sale.

Still, you walked away with a tidy profit, which is not unexpected when selling homes in rarefied areas like Montecito, Calif.; Greenwich, Conn.; or Grosse Pointe, Mich. Such profit is even more common when an older couple that has lived in a house for several decades sells, usually after the kids have left. In both instances, the IRS is going to take its share and, depending on the amount, it could have a huge impact on the seller's plans for the future. A couple of hundred thousand dollars shaved off in taxes could prevent the sellers from buying a new house or preparing for their children's education, and could affect whether and when they can retire.



Commercial or residential real estate investors can elude capital gains taxes in one of two ways: either by making a charitable donation to offset the gains, or by swapping a property in order to postpone the tax bill, a device known as the 1031 Exchange.

But for homeowners, it's a different story.

The majority of Americans' wealth is tied up in home equity, so the IRS treads relatively lightly on profits from home sales in order to protect Americans' wealth. In fact, the majority of American home sellers--more than 90%--won't pay the IRS a dime on gains made from a home sale, or even have to report the property sale to the IRS. How much of an exemption can they expect? When married couples sell, their maximum capital gains exemption is \$500,000. For a single person, it's \$250,000.

"Because most people's only wealth is in their house--and it's often their retirement vehicle--profits [from a home sale] are usually excluded from capital gains taxes," says **Martin Nissenbaum**, national director of personal income tax planning for **Ernst & Young** in New York.

But for those people whose homes have appreciated more in value, it's a different matter.

In some markets, such as New York City and San Francisco, homeowners that bought homes in the 1960s or '70s may still get gouged on capital gains taxes after selling their properties. Between 1996 and 2001 alone, for example, San Francisco home prices rose 71%, according to the Office of Federal Housing Enterprise Oversight. It's not outlandish to presume a family that bought a home in New York for \$100,000 in 1965 will make well

By how much should the IRS raise the capital gains exemption on home sales?

- By \$100,000
- By \$500,000
- By \$1 million
- No limit
- Current exemption is too generous already

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over the \$500,000 tax-free cap if they were to sell it tomorrow.

Reply

Some people may argue that anyone who pockets \$500,000 or more from a home sale has no reason to complain. Nevertheless, according to **Kevin Ondik**, the tax partner at New York accounting and consulting firm **Friedman Alpren & Green**, there are still a couple of basic ways to minimize payments to the IRS.

First of all, home sellers should add up all of the improvements made to the house in order to boost up the base value of the property. For instance, if Joe and Shirley Smith buy a home for \$250,000, then sell it for \$850,000, they are looking at a \$600,000 profit, in which case they will have to pay taxes on the \$100,000 that exceeds the IRS' \$500,000 cap. But if they add the costs of any renovations to the house--such as a new master suite and skylights--to the original cost of the home, it could be boosted to \$300,000, thus shrinking the size of the taxable after-sale gains to \$50,000.

"Buying a new toaster's not going to do you much good, nor will buying anything that can be removed without disturbing the house--but let's say you remodeled the bathrooms and added a new fireplace; those costs can be added to your original cost basis," Ondik says.

In which case, it's important to keep scrupulous records of all home improvements. It may be tempting to use a contractor who gets paid under the table, but the absence of receipts makes it harder to claim the work as an added cost to your home.

It also won't do you any good to pour the profits from your last home into your new home. The gains made on one property can only be minimized by boosting the original cost basis of the home you sold, not by increasing the cost basis of your new home.

Another option--which may be attractive, given the stock market's dismal performance--is simply to unload stocks at a loss in order to offset the capital gains from selling your house. For example, Joe and Shirley Smith (who are now looking at paying taxes on \$50,000 in gains) happen to have some deadweight stocks in their portfolio that haven't seen the light of day in years. If they sell off those stocks at a capital loss of \$50,000, it offsets the gain from their home. Then they don't have to pay the IRS a cent.

If after adding up the costs of home improvements and scoring some spectacular capital losses, home sellers are still required to pay taxes on the profits from their home, tax accountants say it's time to grin and bare it.

"In some markets, a \$500,000 gain may be measly," Nissenbaum says. "But at the end of the day, the IRS is trying to protect the middle class, and there isn't really a good reason per se for the IRS to exclude [taxes] on gains of more than \$500,000."

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