Kramer & Jensen LLC
Certified Public Accountants

Contact Us:

Kramer & Jensen LLC
7430 E. Caley Ave. Suite 300E
Centennial, CO 80111
T 303-741-2253
F 855-330-4215
sjensen@kramerjensen.com

Newsletter August 2022

Sold or Thinking of Selling Your Home?

If you sold your home this year or are thinking about selling it, there are many tax-related issues that could apply to that sale. To help you prepare for reporting the sale you may have already made or make you aware of what issues you may face if you are in the "thinking about" stage, this article covers the tax basics and some special situations related to home sales and the home-sale gain exclusion.

Home Sale Exclusion – For decades, Congress has encouraged home ownership, including by providing various tax breaks for taxpayers selling their homes. Under the current version of the tax code, you are allowed an exclusion of up to $250,000 ($500,000 for married couples) of gain from the sale of your primary residence if you owned and lived in it for at least 2 of the 5 years counting back from the sale date. You also cannot have previously taken a home-sale exclusion within the 2 years immediately preceding the sale. There is no limit on the number of times you can use the exclusion as long as you meet these time requirements; however, under some extenuating circumstances you may still be able to claim a reduced amount of the exclusion even if you haven't satisfied the time requirements. The home-sale gain exclusion only applies to your main home, not to a second home or a rental property.

2 out of 5 Years Rule – As noted above, you must have used and owned the home for 2 out of the 5 years immediately preceding the sale. The years don't have to be consecutive or the closest to the sale date. Vacations, short absences and short rental periods do not reduce the use period. If you are married, to qualify for the $500,000 exclusion, both you and your spouse must have used the home for 2 out of the 5 years prior to the sale, but only one of you needs to meet the ownership requirement. When only one spouse in a married couple qualifies, the maximum exclusion is limited to $250,000 instead of $500,000.

Although this situation is quite rare, if you acquired the home as part of a tax-deferred exchange (sometimes referred to as a 1031 exchange), then you must have owned the home for a minimum of 5 years before the home-gain exclusion can apply.

If you don't meet the ownership and use requirements, there are some situations in which a prorated exclusion amount may be possible. An example of this situation would be if you were required to sell the home because of extenuating circumstances, such as a job-related move, a health crisis or other unforeseen events. Another rule extends the 5-year period to account for the deployment of military members and certain other government employees. Please call this office if you have not met the 2 out of 5 years rule to see if you qualify for a reduced exclusion.

Business Use of the Home – If you used your home for business and claimed a tax deduction—for instance, for a home office, storing inventory in the home or using it as a day care center—that deduction probably included an amount to account for the home's depreciation. In that case, up to the extent of the gain, the claimed depreciation cannot be excluded.

Figuring Gain or Loss from a Sale – The first step is to determine how much the home cost, combining the purchase price and the cost of improvements. From this total cost, subtract any claimed casualty loss deductions and any depreciation taken on the home. The result is your tax basis. Next, subtract the sale expenses and this tax basis from the sale price. The result is your net gain or loss on the sale of the home.

If the result is negative, the sale is a loss; losses on personal-use property such as homes cannot be claimed for tax purposes.

If the result is a gain, however, subtract any home-gain exclusion (discussed above) up to the extent of the gain. This is your taxable gain, which is, unfortunately, subject to income tax. If you owned the home for at least a year and a day, the gain will be a long-term capital gain; as such, it will be taxed at the special capital-gains rate, which ranges from zero for low-income taxpayers to 20% for high-income taxpayers. Depending on the amount of all of your income, the gain may also be subject to the 3.8% net investment income surtax that was added as part of the Affordable Care Act. The tax computation can be rather complicated, so please call this office for assistance.

If you have owned your home for 25 years or more, you may face another issue that can affect your home's tax basis (discussed above). If you purchased your home before May 7, 1997, after selling another home, instead of a home-gain exclusion of the profit from the home you sold, any gain from the sale would have been deferred to the replacement home. This deferred gain would reduce your current home's tax basis and add to any gain for the current sale. While this situation is rare now, if it applies to you, be sure to look back in your tax records from the year you purchased your home for information about the reinvested gain deferral.

Prior Use as a Rental – If you previously used your home as a rental property, the law includes a provision that prevents you from excluding any gain attributable to the home's appreciation while it was a rental. The law's effective date was the beginning of 2009, which means that you only need to account for rental appreciation starting in that year. This law was passed to prevent landlords moving into their rentals for 2 years so that they could exclude the gains from those properties. Prior to the law change, some landlords had done this repeatedly.

Effect of a Mortgage – Some homeowners mistakenly think that the mortgage they have on their home is included as part of their basis. This is not the case. Proceeds from the home's sale are used to pay off the existing mortgage, and if they are more than the mortgage balance, the excess (less sales expenses) is payable to you when the sale closes. But this is not the profit for tax purposes. The tax profit is the amount described above in "Figuring Gain or Loss from a Sale."

Form 1099-S – Usually, the settlement agent—typically an escrow or title company—prepares IRS Form 1099-S, Proceeds from Real Estate Transactions, which reports the home seller's name, tax ID number, proceeds of the sale, date of the sale, etc. This form is provided to both the IRS and the seller. Note that this form only includes information from the sale; it doesn't provide any basis information to the IRS. Sometimes, sellers think that if the home sale gain exclusion eliminates all of their gain from the sale of their home, they don't need to report the transaction on their tax return. Unfortunately, this thinking could lead to correspondence (i.e., a bill for tax due) from the IRS as it attempts to match the sales price shown on the 1099-S to the seller's tax return. To avoid this interaction with the IRS, you should report the home's sale on your income tax return for the year of the sale; in doing so, you will be including your basis and exclusion information for the IRS.

Records – Assets worth hundreds of thousands of dollars, including your home, need your attention, particularly regarding records. When figuring your gain or loss, you will, at a minimum, need the escrow statement from the purchase, a list of improvements (not maintenance work) with receipts, and the final escrow (settlement) statement from the sale. If you encounter any of the issues discussed in this article, you may need additional documentation.

A few other rare home-sale rules are not included here. As you can see, home-sale computations and tax reporting can be very complicated, so please call this office if you need assistance planning a sale or post-sale reporting.

You May Receive an IRS Form 1099-K This Year

Effective for 2022 and later years, Congress reduced the threshold for the Form 1099-K filing requirement from $20,000 to a mere $600. So, you might ask, what does that have to do with me? This change can impact taxpayers in several ways, some unexpected, so you may find yourself in for a surprise that can be unpleasant in some situations.

This article explores the several ways taxpayers can be affected. But first we need to review the purpose of the 1099-K and what can occur for you to receive one.

The 1099-K was created by the IRS as a means to detect unreported income by businesses. The IRS does that by requiring third-party settlement organizations such as credit card companies, eBay, Venmo and others to report the transactions they've handled for an individual or business on a 1099-K if the gross amount of those transactions exceeds a specified threshold.

Although primarily intended for businesses, there are situations where you may find yourself as the recipient of a 1099-K.

One such situation is where a taxpayer is downsizing and sells personal property on eBay. If the total amount sold is $600 or more the taxpayer will receive a 1099-K. Although these sales are generally not taxable since used personal items are usually sold for less than their cost, the IRS does not know the circumstances of the sale and if the amount is significant, it needs to be reconciled on the individual's tax return. A sale of personal property that results in a loss, is not deductible for tax purposes. In prior years, because the threshold for requiring a 1099-K was $20,000, a 1099-K was never issued to most non-business taxpayers, so there was no concern about reconciliation.

Many taxpayers are also involved in the gig economy selling their products through Etsy, eBay, etc., or hiring out their services on TaskRabbit.

Others may be driving for Uber or Lyft or making deliveries through Door Dash, Uber Eats, etc.

Some individuals have been meeting their tax responsibilities from these activities while others have not, thus prompting Congress to reduce the threshold. In either case, it is important that these individuals keep records of their expenses associated with their income-producing activities to reduce any tax liability.

Since some of these activities are treated as self-employment income, here are other issues to be aware of:

<u>Self-employment tax</u> – Which is like Social Security and Medicare taxes paid by employees and matched by the employer through payroll taxes. Except a self-employed individual pays both the employee's and the employer's share, which combined can total 15.3% of net profit.

<u>Self-employment Retirement</u> – Self-employment Income qualifies for IRA contributions and the very popular Simplified Employee Pension Plan (SEP) where a self-employed individual can contribute a tax-deductible amount of 20% of their net earnings to the retirement plan.

<u>Self-Employed Health Insurance Deduction</u> – Most self-employed individuals can deduct as an above-the-line expense 100% of the amount paid during the tax year for medical insurance on behalf of the taxpayer, spouse, dependents, and children under age 27 even if the child is not a dependent. However, this deduction is limited to the net income from the business.

<u>Hobby vs. Business</u> – Whether the activity is truly a business or just a hobby impacts how the income is reported on the tax return, deductibility of expenses (including medical insurance premiums), whether self-employment tax applies, and if contributions to retirement plans can be based on the activity's income.

As you can see, all of this can become quite complicated and the penalties for not reporting income can be severe. Please contact this office if you have any questions or concerns about the form 1099-K.

Thank you for selecting our firm for your tax and accounting needs. We appreciate the confidence you have shown in us, and we remain ready to assist you at any time.

Scott Jensen
Kramer & Jensen, LLC

VISIT OUR WEBSITE

SPREAD THE WORD
SHARE THIS EMAIL

Kramer & Jensen, LLC
sjensen@kramerjensen.com

Share This Email as Webpage

KEEP UP ON THE LATEST
SIGN UP FOR OUR EMAILS