Moving Away (from / to US) and Would Like to Sale your Principal Residence, Maintain it or Rent it?

Sale of a Principal Residence Exclusion Rules and Rental of foreign/ US Properties

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The goal of this article is to provide a comprehensive checklist of information to consider prior to filing a tax return. This article is not designed to teach you the technical competence required to perform self compliance; however it will certainly arm you with the knowledge to determine if your US tax preparer knows all that they should know to provide you with technically competent professional services.

Exclusion rules on Sale of a Principal Residence:

If the home is your “main home” or principal residence in the five year window prior to sale you must have: 1) owned and 2) used or lived in the home for at least two years= 24 months = 730 days for both spouses to qualify for the $250,000 per spouse gain exclusion.

The two years for the owned and use test do not have to be the same two years within the five years prior to sale. Further the determination of “main home” is made on an annual basis, such that there may be multiple “main home” determinations in any five year window. The use test does not require 730 consecutive days of use, as long as there are 730 days in the corresponding five year window and use may occur during periods of non-ownership. Temporary absences even if rented out are counted as periods of use. Lastly this exclusion may only be used once every two years.

If you do not have the two years for both tests you will not qualify for the exclusion unless: you have a change in location of employment, health reasons or for unforeseen circumstances. In such cases the exclusion is prorated by qualifying days over 730 days.

Obviously the handicap for US expats abroad with homes in the US or foreigners here in the US on assignments with homes outside the US is that although they usually meet the two year test of ‘ownership’ they DO NOT meet the ‘use’ test.

If the home is NOT your "main home" or principal residence or you do not meet the above ‘use or ownership’ tests and you have held the residence for more than one year then the gain would be taxed at the long term capital gain rate, which is currently 15%.

Minimizing the Net Unexcluded Gain on Sale:

They key to minimizing your capital gain on sale subject to the US long term capital gains tax rate currently as above t 15%, is to minimize your net capital gain. The net capital gain is comprised of the net proceeds less the net costs. The goal is minimizing net proceeds and maximizing net costs, the closer these two amounts become the smaller the capital gain. Although gross proceeds and gross costs are readily determinable, the net amounts may be more elusive to calculate. To do this you will need the HUD 1 (Housing Urban Development) closing and settlement statements, or the foreign equivalents of these documents from both purchase and sale.

To maximize the net cost purchase price to the contract price, you must add the closing and settlement costs- legal, mortgage recording tax, insurance, hazard, transfer tax, etc as per the HUD settlement statement to bump up the cost to your net costs on purchase. To that amount you would also add you would add subsequent improvements and additions.

To minimize net sale proceeds, to the gross proceeds you must subtract the closing and settlement costs- broker commission, legal, etc as per the HUD 1 settlement statement to reduce the net gain as small as possible. Of course this should be attempted only with the guidance and expertise of a Certified Public Accountant (CPA).

Maintaining your Principal Residence while Abroad/ in the US:

If you decide to maintain your US or foreign residence while living abroad or while living in the US, the mortgage interest and real estate taxes are deductible in the year that they are paid on Schedule A of Form 1040. As US resident aliens- whether by US citizenship, US permanent residency (green card) or those persons that meet the Substantial Presence Test (SPT), your worldwide income is 100% US taxable as are your worldwide deductions 100% US deductible.

Renting it out:

Whether renting out a non US residence while residing in the US or a US residence while residing outside the US overseas, as a US resident alien worldwide taxability becomes a factor. Net rental activity is reported on IRS Form 1040- Schedule E. Schedule E supports inclusion of calendar year cash received rental income as well as a host of straight forward deductions, including: mortgage interest, real –estate taxes, cleaning, maintenance, repairs, commission, insurance, advertising, management fees, supplies, utilities, legal and professional, travel, and others such as snow removal, condo fees, etc…

Additionally depreciation is a mandatory US deduction. Failing to claim depreciation results in you being deemed to have claimed it. For US located rental properties the depreciation rate is 27.5 years straight line, while for foreign properties the rate is 40 years straight line.

On sale there is a recapture of this prior claimed depreciation allowed or allowable, that in effect is included in the gain on sale exclusion calculation to form part of a fully taxable capital gain.

Further rental activity is considered a passive activity. Passive activity losses are only allowed to the extent of passive activity gains or income. Although there is a Special Allowance for rental real estate with active participation, for persons with adjusted gross income under $150,000 to a maximum special allowance of $25,000. Failing this the passive annual rental losses are suspended indefinitely and carried forward until such time as either the property or group of properties is sold or income drops below the $150,000 barrier, at which point the suspended losses carried forward are triggered.

There is a special election IRC Sec. 469(j)(7) to treat the mortgage interest of a principal residence rented out as in effect by-passing the passive activity rules, therefore in effect triggering a rental loss to the extent of the mortgage interest annual claim. This mortgage interest would be termed Qualified Residence Interest. However these rules have been recently challenged and aggressively audited by the IRS ensuring that the home meets the Qualified Residence rules as delineated in IRC Sec. 121. Basically the home must be your main home where one may not have more than one main home at any time and the determination depends on the facts and circumstances of each case. However it stands that a rental that lasts for several years may indicate that the property is no longer a principal residence and, therefore may no longer qualify as Qualified Residence Interest eligible for the IRC Sec. 469(j)(7) election.

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