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SALE OF YOUR PRINCIPAL RESIDENCE AND PA PERSONAL INCOME TAX IMPLICATIONS



Generally, homeowners who owned and used their homes as principal residences for at least two of the five years prior to the date of sale will qualify for exclusion of the gain from the sale of a personal residence from PA taxable income.



What is a residence?

A residence is a house, lodging or other place of habitation, including a trailer or condominium that:

- Has independent or self-contained cooking, sleeping and sanitation facilities;
- Was used and physically occupied by a taxpayer for residential purposes; and
- Was not occupied or used by a taxpayer on a sporadic and transient basis, or only for a definite and promptly accomplished purpose.

What are the requirements to exclude from PA-taxable income the gain from the sale of a principal residence?

The seller(s) must meet these four requirements:

(1) Date of Sale: The sale of the principal residence must be after Dec. 31, 1997. The date of the sale is the date the buyer accepts the deed and the title passes from the seller to the buyer, usually the date of settlement.

If the seller postpones delivery of the deed, the sale is the date possession and the burdens and benefits of ownership pass from the seller to the buyer. For a condemnation, the date of the sale is the date the taxpayer receives the condemnation proceeds. For destruction or casualty loss, the date of sale is the date the taxpayer receives the casualty insurance proceeds or damages.

(2) Use: The law requires that a taxpayer used the residence as the principal residence for a total of at least two years during the five-year period preceding the date of sale.

Example: John bought a house in Harrisburg on Jan. 1, 2001. He lived there until July 1, 2002.

He changed jobs and moved to Pittsburgh in July 2002, but he maintained his Harrisburg home. He did not rent it or use it for any other purposes. He moved back to his home in Harrisburg in 2003 and lived there until he sold it in 2005. John meets the requirement for using his house as his principal residence for at least two years during the five-year period preceding the sale.

If John had never moved back to his Harrisburg home, he would not meet the use requirement for this exclusion. Even though he never rented his house or used it for any other purpose, John would have to pay PA income tax on any gain he realized from the sale of his Harrisburg home.

(3) Ownership: The law requires that a taxpayer owned the residence as a principal residence for a total of at least two years during the five-year period preceding the date of sale.

Example: Mary leased one-half of a house in State College and resided there since 2000. In 2002, she bought the entire property and used it as her principal residence until she sold it in 2005. Mary meets the ownership requirement for this exclusion.

However, if Mary had bought the house in 2004, she would not meet the ownership requirement.

Important: The taxpayer does not have to meet the use and ownership requirements simultaneously, but the taxpayer must meet both during the five-year period preceding the date of the sale.

(4) Prior Sale: To qualify for the exclusion, the taxpayer could not have sold another principal residence within the two years preceding the date of sale of the current residence.

Example: Rob and Ann owned and lived in a

house in Johnstown. In February 2002, they moved to Erie and bought a new house. In August 2002, they sold their Johnstown home. They owned and used the Erie home as their principal residence until they sold it in June 2005. They meet all the requirements for this exclusion.

However, if Rob and Ann sold their Johnstown home in August 2003, they would not meet the prior sale requirement for the Erie house's exclusion. They owned and used their house for at least two years during the five-year period preceding the sale, but they would have sold their principal residence within two years of the sale of their next principal residence.

What if a taxpayer meets the use and ownership requirements, but sells his or her principal residence within two years of selling his or her next principal residence?

The taxpayer will not qualify for the exclusion. However, if the principal residence is sold due to an unforeseen change in employment, health or severe financial hardship, a taxpayer could qualify for the exclusion. An unforeseen change is one caused by accident, illness, loss of property, casualty or another unexpected event beyond the control of the taxpayer.

Example: If in the previous example Rob and Ann sold their principal residence in Erie because Ann's employer relocated her to Williamsport, they would qualify for the exclusion from the two-year prior sale provision based on an unexpected change in employment.

If a taxpayer owns more than one home, which is the principal residence?

The principal residence is the home that the taxpayer physically occupied and personally used most during the five years preceding the sale of

the residence. Moving furniture and personal belongings into a residence does not qualify as use. Even if the taxpayer's family physically occupied the residence, it is not the taxpayer's principal residence if he or she did not occupy it.

Example: Bill and Helen purchased a home in Pittsburgh in January 2001, and Bill began working in Philadelphia in March 2001. He leased an apartment there and commuted to Pittsburgh on weekends, holidays and vacations. In January 2005, they sold their Pittsburgh residence. Helen meets the use and ownership requirement for the exclusion, but Bill does not. He meets the ownership requirement, but does not meet the use requirement. He only used his Pittsburgh home for three months in 2001. His principal residence was his apartment in Philadelphia. If they elect to file separate PA tax returns, Helen qualifies for the exclusion on her half of the gain, while Bill must pay PA personal income tax on his half of the gain. If they file jointly, since one spouse met the four requirements, they both qualify for the exclusion.

What if one of the homeowners die?

The authorized representative of a decedent may not claim this exclusion on the final PA tax return of an otherwise qualifying decedent, unless the decedent closed the sale before death. The decedent's estate or trust may not exclude the gain on the sale of the decedent's principal residence.

What if the taxpayer sells the principal residence on an installment basis?

If the owner meets all four requirements, an installment sale qualifies for this exclusion.

What if a principal residence is a mixed-use property (partly used for business, commercial, industrial, rental, investment or other nonresidential purposes) – Could the

taxpayer still qualify for the exclusion?

The taxpayer may be able to exclude a portion of the gain. Gain is determined separately on the portion of the property used for residential purposes and the portion of the property used for other purposes. The gain that is attributable to the property used for nonresidential purposes does not qualify for the exclusion.

What is a mixed-use property?

Examples of mixed-use property include the following:

- A sole proprietor's residence above his retail store;
- A duplex where the owner rents one unit and lives in the other; and
- An office or licensed daycare facility located within a residence.

Mixed use also includes property where the land surrounding the residence is more than the taxpayer reasonably needs for a residence. The land surrounding a farmhouse that the taxpayer uses for commercial agriculture, livestock breeding or dairy purposes is not necessary for residential purposes.

What if some time during the period a taxpayer owned a home, a portion of the residence was used as a business in the home?

If a taxpayer received or was entitled to a depreciation deduction for having an office in the home, for PA purposes or not, that portion of the home does not qualify for the exclusion. A taxpayer that claimed and received allowable office-at-home depreciation may not exclude the gain on that portion of the principal residence. This applies even if the taxpayer stopped claiming the office-at-home expenses.

How could one spouse qualify and the other not?

If a couple files a joint return and at least one spouse qualifies for the exclusion, they will both qualify. However, if they file separate returns, then they each must qualify for the exclusion individually.

Example: If one spouse lived in an assisted-living facility for the four years immediately preceding the sale of the residence and the other spouse lived in the residence, the spouse that lived in the assisted-living facility does not qualify and must pay tax on his or her share of the gain. The best way to avoid this situation is to file a joint PA income tax return.

If the requirements for the exclusion aren't met, how is gain reported?

Gain or loss is reported on PA Schedule D.

The department supplies a worksheet that assists in calculating a gain on the sale of a principal residence and the taxable portion. The PA-19 worksheet and instructions are available on the department's website, www.revenue.state.pa.us, or by calling 1-888-PATAXES.

If a taxpayer sells a house and qualifies for a full exclusion of the gain, is he required to report any information on/with the PA-40 tax return?

If a taxpayer is eligible for Tax Forgiveness without reporting any gain from the sale of a principal residence, he is required to include the gain from the sale of the home on Line 8 in Part C of PA Schedule SP, Special Tax Forgiveness, in the determination of eligibility income. Otherwise, taxpayers qualifying for the full exclusion of the gain are not required to report or include any additional information or forms with PA-40 income tax returns.