

Publication_523_Selling_Your_Home

*Department of the Treasury
Internal Revenue Service
Produced in electronic format
by Braille International, Inc. 2003*

CONTENTS

<i>Title: Print Page</i>	
<i>Important Changes: 1</i>	
<i>Important Reminders: 2</i>	
<i>Introduction: 2</i>	
<i>Main Home: 3</i>	
<i>Gain or Loss on the Sale: 4</i>	
<i>How To Figure Gain or Loss: 4</i>	
<i>Basis: 5</i>	
<i>Table 1--How To Use Worksheet in Special Situations: 8</i>	
<i>Worksheet 1--Adjusted Basis of Home Sold: 11</i>	
<i>Worksheet 2--Gain (or Loss), Exclusion, and Taxable Gain: 11</i>	
<i>Excluding the Gain: 12</i>	
<i>Worksheet 3--Reduced Maximum Exclusion: 14</i>	
<i>Ownership and Use Tests: 15</i>	
<i>Special Situations: 18</i>	
<i>Reporting the Gain: 18</i>	
<i>Worksheet 1--Adjusted Basis of Home Sold: 20</i>	
<i>Worksheet 2--Gain (or Loss), Exclusion, and Taxable Gain: 20</i>	
<i>SCHEDULE D (Form 1040)--Capital Gains and Losses: 21</i>	
<i>Part I--Short-Term Capital Gains and Losses--Assets Held One Year or Less: 21</i>	
<i>Part II--Long-Term Capital Gains and Losses--Assets Held More Than One Year: 21</i>	
<i>Real Estate and Transfer Taxes: 22</i>	
<i>Recapture of Federal Subsidy: 22</i>	
<i>How To Get Tax Help: 23</i>	
<i>Index: 25</i>	
<i>This electronic edition contains the entire text of the print edition.</i>	

<Page 1>

*Publication 523
Selling Your Home
For use in preparing 2002 Returns*

*Get forms and other information faster and easier by: Computer--www.irs.gov or
FTP--[ftp.irs.gov](ftp://ftp.irs.gov) FAX--(703) 368-9694 (from your fax machine)*

Important Changes

September 11, 2001, terrorist attacks. If you are an individual affected by the September 11, 2001, terrorist attacks and do not meet all the requirements for the maximum exclusion of gain on the sale or exchange of your main home, you may qualify for a reduced maximum exclusion. See Reduced Maximum Exclusion, later. Sale of vacant land. The exclusion of gain from the sale of your main home does not apply to the sale of vacant land unless it is adjacent to your main home, you have owned and used it as part of your main home, it is sold within 2 years of the sale of

your home, and the other requirements for excluding gain have been satisfied. See Main Home, later.

Main home. If you alternate living in two homes, ordinarily the one you live in most of the time is your main home, but there are additional factors to consider in determining which home is your main home. See Main Home, later.

Maximum exclusion--joint owner. You can claim an exclusion of up to \$250,000 of the gain from the sale of your interest in your main home if you are a joint owner, file a separate return, and satisfy the requirements for this exclusion. See Maximum Exclusion, later.

Maximum exclusion--joint return. If either spouse does not satisfy all requirements, the maximum exclusion that can be claimed by the couple is the total of the maximum exclusions that each spouse would qualify for if not married and the amounts were figured separately. See Maximum Exclusion, later.

<Page 2>

Reduced maximum exclusion. If you do not satisfy the ownership and use test, or you sell a second home before the end of the 2-year period required for exclusion of gain, you may qualify for a reduced maximum exclusion if the primary reason for sale is a change in place of employment, health, or unforeseen circumstances.

There are certain sets of facts and circumstances (safe harbors) that will be considered as satisfying the primary reason test for the sale of a main home. If the sale of your home does not qualify under one of these safe harbors, there are a number of factors that may be relevant in determining your primary reason for the sale. See Reduced Maximum Exclusion, later.

Change in place of employment. The sale of your main home is because of a change in place of employment if your primary reason for the sale is a change in the location of employment of a qualified individual. There is a safe harbor for a qualified individual whose new place of employment is at least 50 miles farther from the home sold. See Reduced Maximum Exclusion, later.

Health. The sale of your main home is because of health if your primary reason for the sale is to obtain, provide, or facilitate the diagnosis, cure, mitigation, or treatment of disease, illness, or injury of a qualified individual. There is a safe harbor for a qualified individual whose physician recommends a change of home for reasons of health. See Reduced Maximum Exclusion, later.

Unforeseen circumstances. The sale of your main home is because of an unforeseen circumstance if your primary reason for the sale is the occurrence of an event that you do not anticipate before purchasing and occupying your main home. There are safe harbors for specific events such as death or divorce. See Reduced Maximum Exclusion, later.

Figuring reduced maximum exclusion. If you qualify for a reduced maximum exclusion, it is figured by multiplying the maximum exclusion by a fraction. You can use either days or months (but not both) in the fraction. See Worksheet 3, later.

Office in home. If the part of your property used for non-residential purposes is within your home, such as a room used as a home office for a business, you are treated as satisfying the use test for the entire property for purposes of the exclusion whether or not you were entitled to claim any depreciation deductions. See Business Use or Rental of Home, later.

Applying rules retroactively. Generally, you can apply these new rules retroactively if you would otherwise qualify to exclude gain from a sale of your main home before the effective date of the new rules (December 24, 2002), but on or after May 7, 1997, provided the period of limitations for filing an amended return has not expired for the year of sale.

Important Reminders

Change of address. If you change your mailing address, be sure to notify the Internal Revenue Service (IRS) using Form 8822, Change of Address. Mail it to the Internal Revenue Service Center for your old address. (Addresses for the Service Centers are on the back of the form.)

Home sold with undeducted points. If you have not deducted all the points you paid to secure a mortgage on your old home, you may be able to deduct the remaining points in the year of sale. See Points in Part I of Publication 936, Home Mortgage Interest Deduction.

Photographs of missing children. The Internal Revenue Service is a proud partner with the National Center for Missing and Exploited Children. Photographs of missing children selected by the Center may appear in this publication on pages that would otherwise be blank. You can help bring these children home by looking at the photographs and calling 1-800-THE-LOST (1-800-843-5678) if you recognize a child.

Introduction

This publication explains the tax rules that apply when you sell your main home.

Generally, your main home is the one in which you live most of the time.

Gain. If you have a gain from the sale of your main home, you may be able to exclude up to \$250,000 of the gain from your income (\$500,000 on a joint return in most cases). Any gain not excluded is taxable. See Excluding the Gain, later.

Loss. You cannot deduct a loss from the sale of your main home.

Worksheets. Worksheets are included in this publication to help you figure the adjusted basis of the home you sold, the gain (or loss) on the sale, and the amount of the gain that you can exclude.

Reporting the sale. Do not report the sale of your main home on your tax return unless you have a gain and at least part of it is taxable. Report any taxable gain on Schedule D (Form 1040). You may also have to include Form 4797, Sales of Business Property. See Reporting the Gain, later.

Sale before May 7, 1997. If you sold your main home before May 7, 1997, and postponed the gain while serving in the Armed Forces, see Publication 3, Armed Forces Tax Guide, for special rules that are not covered in this publication.

Date of sale. If you received a Form 1099-S, Proceeds From Real Estate Transactions, the date of sale should be shown in box 1. If you did not receive this form, the date of sale is the earlier of (a) the date title transferred or (b) the date the economic burdens and benefits of ownership shifted to the buyer. In most cases, these dates are the same.

<Page 3>

What is not covered in this publication. This publication does not cover the sale of rental property, second homes, or vacation homes. For information on how to report those sales, see Publication 544, Sales and Other Dispositions of Assets.

Comments and suggestions. We welcome your comments about this publication and your suggestions for future editions.

You can e-mail us while visiting our web site at www.irs.gov.

You can write to us at the following address:

Internal Revenue Service
Tax Forms and Publications
W:CAR:MP:FP
1111 Constitution Ave. NW
Washington, DC 20224

We respond to many letters by telephone. Therefore, it would be helpful if you would include your daytime phone number, including the area code, in your correspondence.

Useful Items

You may want to see:

Publication

- 521 Moving Expenses
- 527 Residential Rental Property
- 530 Tax Information for First-Time Homeowners
- 544 Sales and Other Dispositions of Assets
- 547 Casualties, Disasters, and Thefts
- 551 Basis of Assets
- 587 Business Use of Your Home
- 936 Home Mortgage Interest Deduction

Form (and Instructions)

- Schedule D (Form 1040) Capital Gains and Losses
- 1040X Amended U.S. Individual Income Tax Return
- 4797 Sales of Business Property
- 8822 Change of Address
- 8828 Recapture of Federal Mortgage Subsidy

See How To Get Tax Help, near the end of this publication, for information about getting these publications and forms.

Main Home

This section explains the term "main home."

Usually, the home you live in most of the time is your main home and can be a:

- House,
- Houseboat,
- Mobile home,
- Cooperative apartment, or

-- Condominium. To exclude gain under the rules in this publication, you generally must have owned and lived in the property as your main home for at least 2 years during the 5-year period ending on the date of sale.

Land. If you sell the land on which your main home is located, but not the house itself, you cannot exclude any gain you have from the sale of the land.

Example. On March 4, 2002, you sell the land on which your main home is located.

You buy another piece of land and move your house to it. This sale is not considered a sale of your main home, and you cannot exclude any gain on the sale of the land.

Vacant land. The sale of vacant land is not a sale of your main home unless:

- It is adjacent to land containing your home,
- You owned and used it as part of your main home,
- The sale of your home satisfies the requirements for exclusion and occurs within 2 years before or 2 years after the date of the sale of the vacant land, and
- The other requirements for excluding gain from the sale of the vacant land have been satisfied. The sale (or sales) of the home and the vacant land are treated as one sale and only one maximum exclusion can be applied to any gain. See Excluding the Gain, later.

More than one home. If you have more than one home, you can exclude gain only from the sale of your main home. You must include in income gain from the sale of any other home. If you have two homes and live in both of them, your main home is ordinarily the one you live in most of the time.

Example 1. You own and live in a house in the city. You also own a beach house, which you use during the summer months. The house in the city is your main home.

Example 2. You own a house, but you live in another house that you rent. The rented house is your main home.

In addition to your living in your home most of the time, other factors are relevant in determining if that home is your main home. Those factors include the following:

- 1) Your place of employment.
- 2) The location of your family members' main home.
- 3) Your mailing address for bills and correspondence.
- 4) The address listed on your:

<Page 4 >

- a) Federal and state tax returns,
- b) Driver's license,
- c) Car registration, and
- d) Voter registration card.
- 5) The location of the banks you use.
- 6) The location of recreational clubs and religious organizations you are a member of.

Property used partly as your main home. If you use only part of the property as your main home, the rules discussed in this publication apply only to the gain or loss on the sale of that part of the property. For details, see Business Use or Rental of Home, later.

Gain or Loss on the Sale

If you sold your main home in 2002, you may be able to exclude from income any gain up to a limit of \$250,000 (\$500,000 on a joint return in most cases). See Excluding the Gain, later. If you can exclude all of the gain, you do not need to report the sale on your tax return.

If you have gain that cannot be excluded, it is taxable. Report it on Schedule D (Form 1040).

If you have a loss on the sale, you cannot deduct it on your return.

The main topics in this section are:

- How to figure gain or loss, and
- Basis.

The following topics are discussed in subsequent sections.

- Excluding the gain,
- Ownership and use tests,
- Special situations,
- Reporting the gain, and
- Real estate and transfer taxes.

This section includes worksheets you can use to figure your gain (or loss) and your exclusion. Use Worksheet 1 to figure the adjusted basis of the home you sold. Use Worksheet 2 to figure the gain (or loss), the exclusion, and the taxable gain (if any) on the sale. In some situations, you may also need to use Worksheet 3 to figure a reduced maximum exclusion.

How To Figure Gain or Loss

To figure the gain or loss on the sale of your main home, you must know the selling price, the amount realized, and the adjusted basis.

Selling price. The selling price is the total amount you receive for your home. It includes money, all notes, mortgages, or other debts assumed by the buyer as part

of the sale, and the fair market value of any other property or any services you receive.

Personal property. The selling price of your home does not include amounts you received for personal property sold with your home. Personal property is property that is not a permanent part of the home. Examples are furniture, draperies, and lawn equipment. Separately stated amounts you received for these items should not be shown on Form 1099-S (discussed later). Any gains from sales of personal property must be included in your income.

Payment by employer. You may have to sell your home because of a job transfer. If your employer pays you for a loss on the sale or for your selling expenses, do not include the payment as part of the selling price. Your employer will include it in box 1 of your Form W-2 and you will include it on line 7 of Form 1040.

Option to buy. If you grant an option to buy your home and the option is exercised, add the amount you receive for the option to the selling price of your home. If the option is not exercised, you must report the amount as ordinary income in the year the option expires. Report this amount on line 21 of Form 1040.

Form 1099-S. If you received Form 1099-S, box 2 (gross proceeds) should show the total amount you received for your home.

However, box 2 will not include the fair market value of any property other than cash or notes, or any services, you received or will receive. Instead, box 4 will be checked to indicate your receipt or expected receipt of these items.

If you can exclude the entire gain, the person responsible for closing the sale generally will not have to report it on Form 1099-S. If you do not receive Form 1099-S, use sale documents and other records to figure the total amount you received for your home.

Amount realized. The amount realized is the selling price minus selling expenses.

Selling expenses. Selling expenses include commissions, advertising fees, legal fees, and loan charges paid by the seller, such as loan placement fees or "points."

Adjusted basis. While you owned your home, you may have made adjustments (increases or decreases) to the basis. This adjusted basis must be determined before you can figure gain or loss on the sale of your home. For information on how to figure your home's adjusted basis, see Basis, later.

Amount of gain or loss. To figure the amount of gain or loss, compare the amount realized to the adjusted basis.

Gain on sale. If the amount realized is more than the adjusted basis, the difference is a gain and, except for any part you can exclude, generally is taxable.

Loss on sale. If the amount realized is less than the adjusted basis, the difference is a loss. A loss on the sale of your main home cannot be deducted.

<Page 5>

Jointly owned home. If you and your spouse sell your jointly owned home and file a joint return, you figure your gain or loss as one taxpayer.

Separate returns. If you file separate returns, each of you must figure your own gain or loss according to your ownership interest in the home. Your ownership interest is determined by state law.

Joint owners not married. If you and a joint owner other than your spouse sell your jointly owned home, each of you must figure your own gain or loss according to your ownership interest in the home. Each of you applies the rules discussed in this publication on an individual basis.

Trading homes. If you trade your old home for another home, treat the trade as a sale and a purchase.

Example. You owned and lived in a home with an adjusted basis of \$41,000. A real estate dealer accepted your old home as a trade-in and allowed you \$50,000 toward a new home priced at \$80,000. This is treated as a sale of your old home for \$50,000 with a gain of \$9,000 (\$50,000 minus \$41,000).

If the dealer had allowed you \$27,000 and assumed your unpaid mortgage of \$23,000 on your old home, your sales price would still be \$50,000 (the \$27,000 trade-in allowed plus the \$23,000 mortgage assumed).

Foreclosure or repossession. If your home was foreclosed on or repossessed, you have a sale.

You figure the gain or loss from the sale in generally the same way as gain or loss from any sale. But the amount of your gain or loss depends, in part, on whether you were personally liable for repaying the debt secured by the home, as shown in the following chart.

IF you were ... not personally liable for the debt

THEN your selling price includes ...

the full amount of debt cancelled by the foreclosure or repossession.

IF you were ... personally liable for the debt

THEN your selling price includes ...

the amount of cancelled debt up to the home's fair market value. You may also have ordinary income, as explained next.

Ordinary income. If you were personally liable for the canceled debt, you may have ordinary income in addition to any gain or loss. If the canceled debt is more than the home's fair market value, you have ordinary income equal to the difference. Report that income on line 21, Form 1040. However, the income from cancellation of debt is not taxed to you if the cancellation is intended as a gift, or if you are insolvent or bankrupt. For more information on insolvency or bankruptcy, see Publication 908, Bankruptcy Tax Guide.

Form 1099-C and Form 1099-A. If your debt is canceled, you may receive Form 1099-C, Cancellation of Debt. Generally, you will receive Form 1099-A, Acquisition or Abandonment of Secured Property, from your lender. This form will have the information you need to determine the amount of your gain or loss and any ordinary income from cancellation of debt.

More information. If part of your home is used for business or rental purposes, see Foreclosures and Repossessions in chapter 1 of Publication 544 for more information. Publication 544 has examples of how to figure gain or loss on a foreclosure or repossession.

Abandonment. If you abandon your home, you may have ordinary income. If the abandoned home secures a debt for which you are personally liable and the debt is canceled, you have ordinary income equal to the amount of canceled debt.

If the home is secured by a loan and the lender knows the home has been abandoned, the lender should send you Form 1099-A or Form 1099-C. See Foreclosure or repossession, earlier, for information about those forms. If the home is later foreclosed on or repossessed, gain or loss is figured as explained in that discussion.

Transfer to spouse. If you transfer your home to your spouse, or to your former spouse incident to your divorce, you generally have no gain or loss (unless the Exception, discussed next, applies). This is true even if you receive cash or other consideration for the home. Therefore, the rules explained in this publication do not apply.

If you owned your home jointly with your spouse and transfer your interest in the home to your spouse, or to your former spouse incident to your divorce, the same rule applies. You have no gain or loss.

A transfer of your home to your spouse, or to your former spouse incident to divorce, does not affect the basis of any new home you buy or build.

Exception. These transfer rules do not apply if your spouse or former spouse is a nonresident alien. In that case, you generally will have a gain or loss.

More information. See Property Settlements in Publication 504, Divorced or Separated Individuals, if you need more information.

Basis

You need to know your basis in your home to determine any gain or loss when you sell it. Your basis in your home is determined by how you got the home. Your basis is its cost if you bought it or built it. If you got it in some other way (inheritance, gift, etc.), its basis is either its fair market value when you got it or the adjusted basis of the person you got it from.

While you owned your home, you may have made adjustments (increases or decreases) to your home's basis. The result of these adjustments is your home's adjusted basis, which is used to figure gain or loss on the sale of your home.

To figure your adjusted basis, you can use Worksheet 1, shown later. A filled-in example of that worksheet is included in the comprehensive Illustrated Example, later.

<Page 6 >

Table 1, shown later, explains how to use Worksheet 1 in certain special situations.

The main topics in this section are:

- Cost as basis,
- Basis other than cost, and
- Adjusted basis.

Cost As Basis

The cost of property is the amount you pay for it in cash, debt obligations, other property, or services.

Purchase. If you buy your home, your basis is its cost to you. This includes the purchase price and certain settlement or closing costs. Generally, your purchase price includes your down payment and any debt, such as a first or second mortgage or notes you gave the seller in payment for the home. If you build, or contract to build, a new home, your purchase price can include costs of construction, as discussed later.

Seller-paid points. If the person who sold you your home paid points on your loan, you may have to reduce your home's basis by the amount of the points as shown in the following chart.

IF you bought your home ... after 1990 but before April 4, 1994

THEN reduce your home's basis by the seller-paid points ...

only if you chose to deduct them as home mortgage interest in the year paid.

IF you bought your home ... after April 3, 1994

THEN reduce your home's basis by the seller-paid points ...

even if you did not deduct them.

If you must reduce your basis by seller-paid points and you use Worksheet 1 to figure your adjusted basis, enter the seller-paid points on line 2 of the worksheet (unless you used the seller-paid points to reduce the amount on line 1).

Settlement fees or closing costs. When you bought your home, you may have paid settlement fees or closing costs in addition to the contract price of the property. You

can include in your basis the settlement fees and closing costs you paid for buying the home. You cannot include in your basis the fees and costs for getting a mortgage loan. A fee paid for buying the home is any fee you would have had to pay even if you paid cash for the home.

Settlement fees do not include amounts placed in escrow for the future payment of items such as taxes and insurance.

Some of the settlement fees or closing costs that you can include in your basis are:

- 1) Abstract fees (abstract of title fees),
- 2) Charges for installing utility services,
- 3) Legal fees (including fees for the title search and preparing the sales contract and deed),
- 4) Recording fees,
- 5) Survey fees,
- 6) Transfer taxes,
- 7) Owner's title insurance, and
- 8) Any amounts the seller owes that you agree to pay, such as:
 - a) Certain real estate taxes (discussed later),
 - b) Back interest,
 - c) Recording or mortgage fees,
 - d) Charges for improvements or repairs, and
 - e) Sales commissions.

Some settlement fees and closing costs you cannot include in your basis are:

- 1) Fire insurance premiums,
- 2) Rent for occupancy of the house before closing,
- 3) Charges for utilities or other services related to occupancy of the house before closing,
- 4) Any fee or cost that you deducted as a moving expense (allowed for certain fees and costs before 1994),
- 5) Charges connected with getting a mortgage loan, such as:
 - a) Mortgage insurance premiums (including VA funding fees),
 - b) Loan assumption fees,
 - c) Cost of a credit report,
 - d) Fee for an appraisal required by a lender, and
 - 6) Fees for refinancing a mortgage.

Real estate taxes. Real estate taxes for the year you bought your home may affect your basis, as shown in the following chart.

IF ... you pay taxes that the seller owed on the home (the taxes up to the date of the sale)

AND ... the seller does not reimburse you

THEN the taxes ... are added to the basis of your home.

IF ... you pay taxes that the seller owed on the home (the taxes up to the date of the sale)

AND ... the seller reimburses you

THEN the taxes ... do not affect the basis of your home.

IF ... the seller paid taxes for you (the taxes beginning on the date of sale)

AND ... you do not reimburse the seller

THEN the taxes ... are subtracted from the basis of your home.

IF ... the seller paid taxes for you (the taxes beginning on the date of sale)

AND ... you reimburse the seller

THEN the taxes ... do not affect the basis of your home.

Construction. If you contracted to have your house built on land you own, your basis is:

- 1) The cost of the land, plus
- 2) The amount it cost you to complete the house, including:
 - a) The cost of labor and materials,
 - b) Any amounts paid to a contractor,
 - c) Any architect's fees,
 - d) Building permit charges,
 - e) Utility meter and connection charges, and
 - f) Legal fees directly connected with building the house.

Your cost includes your down payment and any debt such as a first or second mortgage or notes you gave the seller or builder. It also includes certain settlement or closing costs. You may have to reduce your basis by points the seller paid for you. For more information, see Seller-paid points and Settlement fees or closing costs, earlier.

Built by you. If you built all or part of your house yourself, its basis is the total amount it cost you to complete it. Do not include in the cost of the house:

- The value of your own labor, or
- The value of any other labor you did not pay for.

Temporary housing. If a builder gave you temporary housing while your home was being finished, you must reduce your basis by the part of the contract price that was for the temporary housing. To figure the amount of the reduction, multiply the contract price by a fraction. The numerator is the value of the temporary housing, and the denominator is the sum of the value of the temporary housing plus the value of the home.

Cooperative apartment. Your basis in the apartment is usually the cost of your stock in the co-op housing corporation, which may include your share of a mortgage on the apartment building.

Condominium. To determine your basis in a condominium, use the same rules as for any other home.

Basis Other Than Cost

You must use a basis other than cost, such as fair market value, if you got your home as a gift, from your spouse, as an inheritance, or in a trade. If you got your home in any of these ways, see the following discussion that applies to you. If you want to figure your adjusted basis using Worksheet 1, see Table 1, later, for help.

Fair market value. Fair market value is the price at which property would change hands between a willing buyer and a willing seller, neither having to buy or sell, and both having reasonable knowledge of all necessary facts. Sales of similar property, on or about the same date, may be helpful in figuring the fair market value of the property.

Home received as gift. Use the following chart to find the basis of a home you received as a gift.

IF the donor's adjusted basis at the time of the gift was ... more than the fair market value of the home at the time

THEN your basis is ... the same as the donor's adjusted basis at the time of the gift.

Exception: If using the donor's adjusted basis results in a loss when you sell the home, you must use the fair market value of the home at the time of the gift as your basis. If using the fair market value results in a gain, you have neither gain nor loss.

IF the donor's adjusted basis at the time of the gift was ... equal to or less than the fair market value at that time, and you received the gift before 1977

THEN your basis is ... the smaller of the:

- Donor's adjusted basis, plus any federal gift tax paid on the gift, or
- the home's fair market value at the time of the gift.

IF the donor's adjusted basis at the time of the gift was ... equal to or less than the fair market value at the time, and you received the gift after 1976

THEN your basis is ... the same as the donor's adjusted basis, plus the part of any federal gift tax paid that is due to the net increase in value of the home (explained next).

Part of federal gift tax due to net increase in value. Figure the part of the federal gift tax paid that is due to the net increase in value of the home by multiplying the total federal gift tax paid by a fraction. The numerator (top part) of the fraction is the net increase in the value of the home, and the denominator (bottom part) is the value of the home for gift tax purposes after reduction for any annual exclusion and marital or charitable deduction that applies to the gift. The net increase in the value of the home is its fair market value minus the donor's adjusted basis.

Home received from spouse. You may have received your home from your spouse or from your former spouse incident to your divorce.

Transfers after July 18, 1984. If you received the home after July 18, 1984, there was no gain or loss on the transfer. Your basis in this home is generally the same as your spouse's (or former spouse's) adjusted basis just before you received it. This rule applies even if you received the home in exchange for cash, the release of marital rights, the assumption of liabilities, or other consideration.

If you owned a home jointly with your spouse and your spouse transferred his or her interest in the home to you, your basis in the half interest received from your spouse is

Text continued on print page 9.

<Page 8>

Table 1. How To Use Worksheet 1 in Special Situations

If you use Worksheet 1 to figure the adjusted basis of your home and any of the situations described below apply to you, follow these instructions.

IF ... you inherited your home

THEN ...

1 skip lines 1-4 of the worksheet.

2 find your basis using the rules under Home received as inheritance in this publication. Enter this amount on line 5 of the worksheet.

3 fill out the rest of the worksheet.

IF ... you received your home as a gift

THEN ...

1 read Home received as a gift in this publication and enter on line 1 and 3 of the worksheet either the donor's adjusted basis or the home's fair market value at the time of the gift, whichever is appropriate.

2 if you can add any federal gift tax to your basis, enter that amount on line 5 of the worksheet.

3 fill out the rest of the worksheet.

IF ... you received your home in a trade

THEN ...

1 find your basis using the rules under Home received in trade in this publication.

Enter this amount on line 1 of the worksheet. (But if you received your home in a trade for your previous home before May 7, 1997, and had a gain on the trade that

you postponed using Form 2119, enter on line 1 of the worksheet the adjusted basis of the new home from that Form 2119.)

2 fill out the rest of the worksheet.

IF ... you built your home

THEN ...

1 add the purchase price of the land and the cost of building the home. (See Construction in this publication for details). Enter that total on line 1 of the worksheet. (However, if you received a Form 2119 to postpone gain on the sale of a previous home before May 7, 1997, enter on line 1 of the worksheet the adjusted basis of the new home from that Form 2119.)

2 fill out the rest of the worksheet.

IF ... you received your home from your spouse after July 18, 1984

THEN ...

1 skip lines 1-4 of the worksheet.

2 enter on line 5 of the worksheet your spouse's adjusted basis in the home just before you received it.

3 fill out the rest of the worksheet, making adjustments to basis only for events after the transfer.

IF ... you owned a home jointly with your spouse, who transferred his or her interest in the home to you after July 18, 1984

THEN ...

fill out one worksheet, including adjustments to basis for events both before and after the transfer.

IF ... you received your home from your spouse before July 19, 1984

THEN ...

1 skip lines 1-4 of the worksheet.

2 enter on line 5 of the worksheet the home's fair market value at the time you received it.

3 fill out the rest of the worksheet, making adjustments to basis only for events after the transfer.

IF ... you owned a home jointly with your spouse, and your spouse transferred his or her interest in the home to you before July 19, 1984

THEN ...

1 fill out a worksheet, lines 1-13, making adjustments to basis for events both before and after the transfer.

2 multiply the amount on line 13 of that worksheet by one-half (0.5) to get the adjusted basis of your half-interest at the time of the transfer.

3 multiply the fair market value of the home at the time of the transfer by one-half (0.5). Generally, this is the basis of the half-interest that your spouse owned.

4 add the amounts from steps 2 and 3 and enter the total on line 5 of a second worksheet.

5 complete the rest of the second worksheet, making adjustments to basis only for events after the transfer.

<Page 9>

IF ... you owned your home jointly with your spouse who died

THEN ...

1 fill out a worksheet, lines 1-13, making adjustments to basis only for events before your spouse's death.

2 multiply the amount on line 13 of that worksheet by one-half (0.5) to get the adjusted basis of your half-interest on the date of death.

3 use the rules under Surviving spouse in this publication to find the basis for the half-interest owned by your spouse.

4 add the amounts from steps 2 and 3 and enter the total on line 5 of a second worksheet.

5 complete the rest of the second worksheet, making adjustments to basis only for events after your spouse's death.

IF ... you owned your home jointly with your spouse who died, and your permanent home is in a community property state

THEN ...

1 skip lines 1-4 of the worksheet.

2 enter the amount of your basis on line 5 of the worksheet. Generally, this is the fair market value of the home at the time of death. (But see Community property in this publication.)

3 fill out the rest of the worksheet, making adjustments to basis only for events after your spouse's death.

IF ... your home was ever damaged as a result of a casualty

THEN ...

1 on line 8 of the worksheet, enter any amounts you spent to restore the home to its condition before the casualty.

2 on line 11 enter:

any insurance reimbursements you received (or expect to receive) for the loss, and any deductible casualty losses not covered by insurance. Text continued from print page 7. generally the same as your spouse's adjusted basis just before the transfer. This also applies if your former spouse transferred his or her interest in the home to you incident to your divorce. Your basis in the half interest you already owned does not change. Your new basis in the home is the total of these two amounts.

Transfers before July 19, 1984. If you received your home before July 19, 1984, in exchange for your release of marital rights, your basis in the home is generally its fair market value at the time you received it.

More information. For more information on property received from a spouse or former spouse, see Property Settlements in Publication 504.

Home received as inheritance. If you inherited your home, your basis is its fair market value on the date of the decedent's death or the later alternate valuation date if that date was chosen by the personal representative for the estate. If an estate tax return was filed, the value listed for the property generally is your basis. If a federal estate tax return did not have to be filed, your basis in the home is the same as its appraised value at the date of death for purposes of state inheritance or transmission taxes.

Surviving spouse. If you are a surviving spouse and you owned your home jointly, your basis in the home will change. The new basis for the half interest that your spouse owned will be one-half of the fair market value on the date of death (or alternate valuation date). The basis in your half will remain one-half of the adjusted basis determined previously. Your new basis is the total of these two amounts.

Example. Your jointly owned home had an adjusted basis of \$50,000 on the date of your spouse's death, and the fair market value on that date was \$100,000. Your new basis in the home is \$75,000 (\$25,000 for one-half of the adjusted basis plus \$50,000 for one-half of the fair market value).

Community property. In community property states (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin), each spouse is usually considered to own half of the community property. When either spouse dies, the fair market value of the community property generally becomes the basis of the entire property, including the part belonging to the surviving spouse. For this to

apply, at least half the value of the community property interest must be includible in the decedent's gross estate, whether or not the estate must file a return. For more information about community property, see Publication 555, Community Property.

Home received in trade. If you acquired your home in a trade for other property, the basis of your home is generally the fair market value of the other property at the time of the trade. If you traded one home for another, you have made a sale and purchase. In that case, you may have realized a gain. See Trading homes, earlier, for an example of figuring the gain.

More information. For more information about basis, get Publication 551.

<Page 10>

Adjusted Basis

Adjusted basis is your basis increased or decreased by certain amounts.

To figure your adjusted basis, you can use Worksheet 1, shown later. A filled-in example of that worksheet is included in a comprehensive Illustrated Example later. Table 1 on the next page explains how to use the worksheet in certain special situations.

Increases to basis. These include any:

- 1) Additions and other improvements that have a useful life of more than 1 year,
- 2) Special assessments for local improvements, and
- 3) Amounts you spent after a casualty to restore damaged property.

Decreases to basis. These include any:

- 1) Gain you postponed from the sale of a previous home before May 7, 1997,
- 2) Deductible casualty losses,
- 3) Insurance payments you received or expect to receive for casualty losses,
- 4) Payments you received for granting an easement or right-of-way,
- 5) Depreciation allowed or allowable if you used your home for business or rental purposes,
- 6) Residential energy credit (generally allowed from 1977 through 1987) claimed for the cost of energy improvements that you added to the basis of your home,
- 7) Adoption credit you claimed for improvements added to the basis of your home,
- 8) Nontaxable payments from an adoption assistance program of your employer that you used for improvements you added to the basis of your home,
- 9) First-time homebuyers credit (allowed to certain first-time buyers of a home in the District of Columbia), and
- 10) Energy conservation subsidy excluded from your gross income because you received it (directly or indirectly) from a public utility after 1992 to buy or install any energy conservation measure. An energy conservation measure is an installation or modification that is primarily designed either to reduce consumption of electricity or natural gas or to improve the management of energy demand for a home.

Improvements. These add to the value of your home, prolong its useful life, or adapt it to new uses. You add the cost of additions and other improvements to the basis of your property.

Examples. Putting a recreation room or another bathroom in your unfinished basement, putting up a new fence, putting in new plumbing or wiring, putting on a new roof, or paving your unpaved driveway are improvements. An addition to your house, such as a new deck, a sunroom, or a new garage, is also an improvement.

The following chart lists some other examples of improvements.

Additions

Bedroom

Bathroom
Deck
Garage
Porch
Patio
Lawn & Grounds
Landscaping
Driveway
Walkway
Fence
Retaining wall
Sprinkler system
Swimming pool
Miscellaneous
Storm windows, doors
New roof
Central vacuum
Wiring upgrades
Satellite dish
Security system
Heating & Air Conditioning
Heating system
Central air conditioning
Furnace
Duct work
Central humidifier
Filtration system
Plumbing
Septic system
Water heater
Soft water system
Filtration system
Interior Improvements
Built-in appliances
Kitchen modernization
Flooring
Wall-to-wall carpeting
Insulation
Attic
Walls, floor
Pipes, ductwork

Improvements no longer part of home. Your home's adjusted basis does not include the cost of any improvements that are no longer part of the home.

Example. You put wall-to-wall carpeting in your home 15 years ago. Later, you replaced that carpeting with new wall-to-wall carpeting. The cost of the old carpeting you replaced is no longer part of your home's adjusted basis.

Repairs. These maintain your home in good condition but do not add to its value or prolong its life. You do not add their cost to the basis of your property.

Examples. Repainting your house inside or outside, fixing your gutters or floors, repairing leaks or plastering, and replacing broken window panes are examples of repairs.

Exception. The entire job is considered an improvement if items that would otherwise be considered repairs are done as part of an extensive remodeling or restoration of your home.

RECORDS: Recordkeeping. You should keep records to prove your home's adjusted basis. Ordinarily, you must keep records for 3 years after the due date for filing your return for the tax year in which you sold your home. But if you sold a home before May 7, 1997, and

Text continued on print page 12.

<Page 11>

Worksheet 1. Adjusted Basis of Home Sold

Caution: See if any of the situations listed in Table 1 apply to you before you use this worksheet. 1. Enter the purchase price of the home sold. (If you filed Form 2119 when you originally acquired that home to postpone gain on the sale of a previous home before May 7, 1997, enter the adjusted basis of the new home from that Form 2119.): ----

2. Seller-paid points, for home bought after 1990. (See Seller-paid points in this chapter.) Do not include any seller-paid points you already subtracted to arrive at the amount entered on line 1 above: ----

3. Subtract line 2 from line 1: ----

4. Settlement fees or closing costs. See Settlement fees or closing costs. If line 1 includes the adjusted basis of the new home from Form 2119, go to line 6.

4a. Abstract and recording fees: ----

4b. Legal fees (including title search and preparing documents): ----

4c. Surveys: ----

4d. Title insurance: ----

4e. Transfer or stamp taxes: ----

4f. Amounts that the seller owed that you agreed to pay (back taxes or interest, recording or mortgage fees, and sales commissions): ----

4g. Other: ----

5. Add lines 4a through 4g: ----

6. Cost of additions and improvements. Do not include any additions and improvements included on line 1 above: ----

7. Special tax assessments paid for local improvements, such as streets and sidewalks: ----

8. Other increases to basis: ----

9. Add lines 3, 5, 6, 7, and 8: ----

10. Depreciation, related to the business use or rental of the home, claimed (or allowable): ----

11. Other decreases to basis (see Decreases to basis.): ----

12. Add lines 10 and 11: ----

13. ADJUSTED BASIS OF HOME SOLD. Subtract line 12 from line 9. Enter here and on Worksheet 2, line 4: ----

Worksheet 2. Gain (or Loss), Exclusion, and Taxable Gain

Part 1--Gain (or Loss) on Sale 1. Selling price of home: ----

2. Selling expenses: ----

3. Subtract line 2 from line 1: ----

4. Adjusted basis of home sold (from Worksheet 1, line 13): ----

5. Subtract line 4 from line 3. This is the gain (or loss) on the sale. If this is a loss, stop here: ----

Part 2--Exclusion and Taxable Gain 6. Enter any depreciation allowed or allowable on the property for periods after May 6, 1997. If none, enter zero: ----

7. Subtract line 6 from line 5. (If the result is less than zero, enter zero.): ----
8. If you qualify to exclude gain on the sale, enter your maximum exclusion. (See Maximum Amount of Exclusion earlier.) If you do not qualify to exclude gain, enter 0: ----
9. Enter the smaller of line 7 or line 8. This is your exclusion: ----
10. Subtract line 9 from line 5. This is your taxable gain. Report it as described under Reporting the Gain on page 16. If the amount on this line is zero, do not report the sale or exclusion on your tax return. If the amount on line 6 is more than zero, complete line 11: ----
11. Enter the smaller of line 6 or line 10. Enter this amount on line 12 of the Unrecaptured Section 1250 Gain Worksheet in the instructions for Schedule D (Form 1040): ----

<Page 12>

Text continued from print page 10. postponed tax on any gain, the basis of that home affects the basis of the new home you bought. Keep records proving the basis of both homes as long as they are needed for tax purposes.

The records you should keep include:

- Proof of the home's purchase price and purchase expenses,
- Receipts and other records for all improvements, additions, and other items that affect the home's adjusted basis,
- Any worksheets you used to figure the adjusted basis of the home you sold, the gain or loss on the sale, the exclusion, and the taxable gain,
- Any Form 2119, Sale of Your Home, that you filed to postpone gain from the sale of a previous home before May 7, 1997, and
- Any worksheets you used to prepare Form 2119, such as the Adjusted Basis of Home Sold Worksheet or the Capital Improvements Worksheet from the Form 2119 instructions.

Excluding the Gain

You may qualify to exclude from your income all or part of any gain from the sale of your main home. This means that, if you qualify, you will not have to pay tax on the gain up to the limit described under Maximum Amount of Exclusion, next. To qualify, you must meet the ownership and use tests described later.

You can choose not to take the exclusion by including the gain from the sale in your gross income on your tax return for the year of the sale. This choice can be made (or revoked) at any time before the expiration of a 3-year period beginning on the due date of your return (not including extensions) for the year of the sale.

You can use Worksheet 2 to figure the amount of your exclusion and your taxable gain, if any.

Maximum Amount of Exclusion

You can exclude up to \$250,000 of the gain on the sale of your main home if all of the following are true.

- 1) You meet the ownership test.
- 2) You meet the use test.
- 3) During the 2-year period ending on the date of the sale, you did not exclude gain from the sale of another home. This exclusion also applies to the gain attributable to your interest in your main home if you are a joint owner, file a separate return, and the 3 items above are true.

You can exclude up to \$500,000 of the gain on the sale of your main home if all of the following are true.

- 1) You are married and file a joint return for the year.
- 2) Either you or your spouse meets the ownership test.
- 3) Both you and your spouse meet the use test.
- 4) During the 2-year period ending on the date of the sale, neither you nor your spouse excluded gain from the sale of another home. If either spouse does not satisfy all these requirements, the maximum exclusion that can be claimed by the couple is the total of the maximum exclusions that each spouse would qualify for if not married and the amounts were figured separately. For this purpose, each spouse is treated as owning the property during the period that either spouse owned the property.

Reduced Maximum Exclusion

You can claim an exclusion, but the maximum amount of gain you can exclude will be reduced if either of the following is true.

- 1) You did not meet the ownership and use tests, but the primary reason you sold the home was:
 - a) A change in place of employment,
 - b) Health, or
 - c) Unforeseen circumstances, to the extent provided in regulations (as discussed below).
- 2) Your exclusion would have been disallowed because of the rule described in More Than One Home Sold During 2-Year Period, later, except that the primary reason you sold the home was:
 - a) A change in place of employment,
 - b) Health, or
 - c) Unforeseen circumstances, to the extent provided in regulations (as discussed below). Use Worksheet 3 to figure your reduced maximum exclusion. When completing the worksheet, you can use either days or months (but not both) to figure your reduced maximum exclusion.

Primary reason. There are certain sets of facts and circumstances (safe harbors), described later, that will be treated as satisfying the primary reason test for the sale of a main home. If your home sale does not qualify under one of these safe harbors, factors that may be relevant in determining your primary reason for sale include the following.

- 1) Your financial ability to maintain your home materially changed.
- 2) The suitability of your property as a home materially changed.
- 3) The circumstances causing your sale were not reasonably foreseeable when you began using the property as your main home.

<Page 13>

- 4) During the time you owned the property, you used it as your home.
 - 5) The circumstances causing your sale occurred during the time you owned and used the property as your main home.
 - 6) Your sale and the circumstances causing it were close in time.
- Change in place of employment. The sale of your main home is because of a change in place of employment if your primary reason for the sale is a change in the location of employment of a qualified individual.
- Qualified individual. For purposes of the reduced maximum exclusion, a qualified individual is any of the following.
- The taxpayer.
 - The taxpayer's spouse.
 - A co-owner of the residence.
 - A person whose main home is the same as the taxpayer's.

Employment. For this purpose, employment includes the start of work with a new employer or continuation of work with the same employer. It also includes the start or continuation of self-employment.

Distance safe harbor. The primary reason for the sale of your main home is a change in place of employment if:

- 1) The change occurred during the period you owned and used the property as your main home, and
- 2) The new place of employment is at least 50 miles farther from your home than the former place of employment was.

Example. Justin was unemployed and living in a townhouse in Florida that he had owned and used as his main home since 2001. He got a job in North Carolina and sold his townhouse in 2002. Because the distance between Justin's new place of employment and the home he sold is at least 50 miles, the sale satisfies the conditions of the distance safe harbor. Justin's sale of his home is because of a change in place of employment and he is entitled to a reduced maximum exclusion of gain from the sale.

Health. The sale of your main home is because of health if your primary reason for the sale is to obtain, provide, or facilitate the diagnosis, cure, mitigation, or treatment of disease, illness, or injury of a qualified individual. For purposes of this reason, a qualified individual includes, in addition to the individuals listed earlier, any of the following:

- Parent, grandparent, stepmother, stepfather,
- Child, grandchild, stepchild, adopted child,
- Brother, sister, stepbrother, stepsister, half brother, half sister,
- Mother-in-law, father-in-law, brother-in-law, sister-in-law, son-in-law, or daughter-in-law,
- Uncle, aunt, nephew, or niece.

Example. In 2001, Chase and Lauren, husband and wife, bought a house that they used as their main home. Lauren's father has a chronic disease and is unable to care for himself. In 2002, Chase and Lauren sell their home in order to move into Lauren's father's house to provide care for him. Because the primary reason for the sale of their home was the health of a qualified individual, Chase and Lauren are entitled to a reduced maximum exclusion.

Doctor's recommendation safe harbor. The primary reason for the sale of your main home is because of health if, for one or more of the reasons listed at the beginning of this discussion, a doctor recommends a change of residence.

Unforeseen circumstances. The sale of your main home is because of an unforeseen circumstance if your primary reason for the sale is the occurrence of an event that you do not anticipate before purchasing and occupying your main home.

Specific event safe harbors. If the sale of your main home is because of any of the following events, the primary reason for your sale is an unforeseen circumstance and you are entitled to a reduced maximum exclusion.

- 1) An involuntary conversion of your home.
- 2) Natural or man-made disasters or acts of war or terrorism resulting in a casualty to your home, whether or not your loss is deductible.
- 3) In the case of qualified individuals (listed earlier under Change in place of employment):
 - a) Death,
 - b) Unemployment (if the individual is eligible for unemployment compensation),
 - c) A change in employment or self-employment status that results in your (if you are the taxpayer) inability to pay reasonable basic living expenses (listed later under Reasonable basic living expenses),
 - d) Divorce or legal separation, or

e) Multiple births resulting from the same pregnancy.

4) An event the Commissioner of IRS determined to be an unforeseen circumstance to the extent provided in published guidance and rulings. (See September 11, 2001, terrorists attacks, next.)

September 11, 2001, terrorist attacks. Recently, the IRS issued a notice explaining the circumstances under which these terrorist attacks qualify as unforeseen circumstances for the purpose of claiming a reduced maximum exclusion. The notice provides that a taxpayer can claim a reduced maximum exclusion of gain on a sale of the

<Page 14>

taxpayer's main home because of unforeseen circumstances if the taxpayer sells the home as a result of being affected by the September 11, 2001, terrorist attacks in one or more of the following ways.

- 1) A qualified individual (as defined below) was killed.
- 2) A qualified individual lost employment and became eligible for unemployment compensation (as defined by federal law).
- 3) A qualified individual experienced a change in employment or self-employment that resulted in the taxpayer's inability to pay reasonable basic living expenses (as defined below) for the taxpayer's household.
- 4) The taxpayer's main home was damaged (even if the taxpayer is entitled to a casualty loss deduction).

Qualified individual. The term "qualified individual" means, as of September 11, 2001, any of the following.

- The taxpayer.
- The taxpayer's spouse.
- A co-owner of the home.
- A person whose main home is the same as the taxpayer's.

Reasonable basic living expenses. Reasonable basic living expenses for the taxpayer's household include the following expenses.

- Amounts spent for food.
- Amounts spent for clothing.
- Housing and related expenses.
- Medical expenses.
- Transportation expenses.
- Tax payments.
- Court-ordered payments.
- Expenses reasonably necessary to produce income.

Amounts spent on these items to maintain an affluent or luxurious standard of living are not reasonable basic living expenses.

2001 home sales. Taxpayers affected by the September 11, 2001, terrorist attacks who qualify for a reduced maximum exclusion of gain on a 2001 sale of their main home can claim the exclusion on their 2001 return. Taxpayers who have filed their return for 2001 can file an amended return to claim the exclusion.

Worksheet 3.

Reduced Maximum Exclusion

Caution: Complete this worksheet only if you qualify for a reduced maximum exclusion. (See Reduced Maximum Exclusion earlier.) Complete column (B) only if you are married filing a joint return. 1. Maximum amount: (A) You \$250,000.00, (B) Your Spouse \$250,000.00

- 2a. Enter the number of days (or months) that you used the property as a main home during the 5-year period ending on the date of sale. (If married filing jointly, fill in columns (A) and (B)): (A) You ---- (B) Your Spouse ----
- 2b. Enter the number of days (or months) that you owned the property during the 5-year period ending on the date of sale. (If married filing jointly and one spouse owned the property longer than the other spouse, both spouses are treated as owning the property for the longer period):
(A) You ---- (B) Your Spouse ----
- 2c. Enter the smaller of line 2a or 2b: (A) You ---- (B) Your Spouse ----
3. Have you (or your spouse if filing jointly) excluded gain from the sale of another home during the 2-year period ending on the date of this sale?
NO. Skip line 3 and enter the number of days (or months) from line 2c on line 4.
YES. Enter the number of days (or months) between the date of the most recent sale of another home on which you excluded gain and the date of sale of this home: (A) You ---- (B) Your Spouse ----
4. Enter the smaller of line 2c or 3: (A) You ---- (B) Your Spouse ----
5. Divide the amount on line 4 by 730 days (or 24 months). Enter the result as a decimal (rounded to at least 3 places). But do not enter an amount greater than 1.000: (A) You ---- (B) Your Spouse ----
6. Multiply the amount on line 1 by the decimal amount on line 5: (A) You ---- (B) Your Spouse ----
7. Add the amounts in column (A) and (B) of line 6. This is your reduced maximum exclusion. Enter it here and on Worksheet 2, line 8: ----

More Than One Home Sold During 2-Year Period

You cannot exclude gain on the sale of your home if, during the 2-year period ending on the date of the sale, you sold another home at a gain and excluded all or part of that

<Page 15>

gain. If you cannot exclude the gain, you must include it in your income.

However, you can still claim an exclusion if you sold the home due to:

- 1) A change in place of employment,
- 2) Health, or
- 3) Unforeseen circumstances, to the extent provided in regulations (as discussed earlier). The maximum amount you can exclude is reduced. See Reduced Maximum Exclusion, earlier.

Example 1. In September 2000, Paul and Nadine bought a new home. In November 2000, they sold their old home at a \$40,000 gain. They had owned and lived in the old home for 4 years. They excluded the gain on the sale.

On October 1, 2002, Paul and Nadine sold the home they purchased in September 2000 at a \$15,000 gain. The sale was not due to a change in place of employment or health. Because Paul and Nadine had excluded gain on the sale of another home within the 2-year period ending on October 1, 2002, they cannot exclude the gain on this sale.

Example 2. The facts are the same as in Example 1 except that Paul and Nadine did not sell the home purchased in September 2000 until December 3, 2002. Because they had not excluded gain on the sale of another home within the 2-year period ending on December 3, 2002, they can exclude the gain on this sale.

Ownership and Use Tests

To claim the exclusion, you must meet the ownership and use tests. This means that during the 5-year period ending on the date of the sale, you must have:

- 1) Owned the home for at least 2 years (the ownership test), and
- 2) Lived in the home as your main home for at least 2 years (the use test).

Exception. If you owned and lived in the property as your main home for less than 2 years, you can still claim an exclusion in some cases. The maximum amount you can exclude will be reduced. See Reduced Maximum Exclusion, earlier.

Example 1--met use test but not ownership test. From 1993 through August 2001 Donna lived with her parents in a house that her parents owned. On September 1, 2001, she bought this house from her parents. She continued to live there until December 14, 2002, when she sold it at a gain. Although Donna lived in the property as her main home for more than 2 years, she did not own it for the required 2 years. She cannot exclude any part of her gain on the sale, unless she sold the property due to a change in place of employment or health.

Example 2--change in place of employment. Amanda, who is single, bought her first home in August 2000. In December 2001 the company she worked for notified her that she would be transferred to another town in 2002. She continued to live in the home until June 2002, when she sold it at a gain and moved to the new town. Because she owned and lived in the home less than 2 years, she does not meet the ownership and use tests. However, she qualifies to exclude gain because she sold the home due to a change in place of employment. She can use Worksheet 3, shown earlier, to figure the maximum amount of gain she can exclude. It will be less than \$250,000.

Period of Ownership and Use

The required 2 years of ownership and use during the 5-year period ending on the date of the sale do not have to be continuous.

You meet the tests if you can show that you owned and lived in the property as your main home for either 24 full months or 730 days (365 times 2) during the 5-year period ending on the date of sale.

Example. Susan bought and moved into a house in July 1998. She lived there for 13 months and then moved in with a friend. She moved back into her own house in 2001 and lived there for 12 months until she sold it in July 2002. Susan meets the ownership and use tests because, during the 5-year period ending on the date of sale, she owned the house for 4 years and lived in it for a total of 25 months. Temporary absence. Short temporary absences for vacations or other seasonal absences, even if you rent out the property during the absences, are counted as periods of use.

Example. Professor Paul Beard, who is single, bought and moved into a house on August 28, 1999. He lived in it as his main home continuously until January 5, 2001, when he went abroad for a 1-year sabbatical leave. During part of the period of leave, the house was unoccupied, and during the rest of the period, he rented it. On January 5, 2002, he sold the house at a gain. Because his leave was not a short temporary absence, he cannot include the period of leave to meet the 2-year use test. He cannot exclude any part of his gain, unless he sold the house due to a change in place of employment or health. Even if he did sell the house due to a change in place of employment or health, he cannot exclude the part of the gain equal to the depreciation he claimed or should have claimed while renting the house. See Depreciation after May 6, 1997, later.

Ownership and use tests met at different times. You can meet the ownership and use tests during different 2-year periods. However, you must meet both tests during the 5-year period ending on the date of the sale.

Example. In 1993, Helen Jones lived in a rented apartment. The apartment building was later changed to a condominium, and she bought her apartment on Decem-

<Page 16>

ber 1, 1999. In 2000, Helen became ill and on April 14 of that year she moved to her daughter's home. On July 10, 2002, while still living in her daughter's home, she sold her apartment.

Helen can exclude gain on the sale of her apartment because she met the ownership and use tests. Her 5-year period is from July 11, 1997, to July 10, 2002, the date she sold the apartment. She owned her apartment from December 1, 1999, to July 10, 2002 (more than 2 years). She lived in the apartment from July 11, 1997 (the beginning of the 5-year period), to April 14, 2000 (more than 2 years).

Cooperative apartment. If you sold stock in a cooperative housing corporation, the ownership and use tests are met if, during the 5-year period ending on the date of sale, you:

- 1) Owned the stock for at least 2 years, and
- 2) Lived in the house or apartment that the stock entitles you to occupy as your main home for at least 2 years.

Exception for individuals with a disability. There is an exception to the use test if, during the 5-year period before the sale of your home:

- 1) You become physically or mentally unable to care for yourself, and
- 2) You owned and lived in your home as your main home for a total of at least 1 year. Under this exception, you are considered to live in your home during any time that you own the home and live in a facility (including a nursing home) that is licensed by a state or political subdivision to care for persons in your condition.

If you meet this exception to the use test, you still have to meet the 2-out-of-5-year ownership test to claim the exclusion.

Gain postponed on sale of previous home. For the ownership and use tests, you may be able to add the time you owned and lived in a previous home to the time you lived in the home on which you wish to exclude gain. You can do this if you postponed all or part of the gain on the sale of the previous home (under rules in effect before May 7, 1997) because of buying the home on which you wish to exclude gain.

Previous home destroyed or condemned. For the ownership and use tests, you add the time you owned and lived in a previous home that was destroyed or condemned to the time you owned and lived in the home on which you wish to exclude gain. This rule applies if any part of the basis of the home you sold depended on the basis of the destroyed or condemned home. Otherwise, you must have owned and lived in the same home for 2 of the 5 years before the sale to qualify for the exclusion.

Married Persons

If you and your spouse file a joint return for the year of sale, you can exclude gain if either spouse meets the ownership and use tests. (But see Maximum Amount of Exclusion, earlier.)

Example 1--one spouse sells a home. Emily sells her home in June 2002. She marries Jamie later in the year. She meets the ownership and use tests, but Jamie does not. Emily can exclude up to \$250,000 of gain on a separate or joint return for 2002.

Example 2--each spouse sells a home. The facts are the same as in Example 1 except that Jamie also sells a home in 2002. He meets the ownership and use tests on his home. Emily and Jamie can each exclude up to \$250,000 of gain.

Death of spouse before sale. If your spouse died before the date of sale, you are considered to have owned and lived in the property as your main home during any period of time when your spouse owned and lived in it as a main home.

Home transferred from spouse. If your home was transferred to you by your spouse (or former spouse if the transfer was incident to divorce), you are considered to have owned it during any period of time when your spouse owned it.

Use of home after divorce. You are considered to have used property as your main home during any period when:

- 1) You owned it, and
- 2) Your spouse or former spouse is allowed to live in it under a divorce or separation instrument.

Business Use or Rental of Home

You may be able to exclude your gain from the sale of a home that you have used for business or to produce rental income. But you must meet the ownership and use tests.

Example 1. On May 30, 1996, Amy bought a house. She moved in on that date and lived in it until May 31, 1998, when she moved out of the house and put it up for rent. The house was rented from June 1, 1998, to March 31, 2000. Amy moved back into the house on April 1, 2000, and lived there until she sold it on January 31, 2002. During the 5-year period ending on the date of the sale (February 1, 1997-January 31, 2002), Amy owned and lived in the house for more than 2 years as shown in the table below.

Note: In this table, columns follow each other in this order: Five Year Period: Used as Home; Used as Rental. 2-1-97--5-31-98: 16 months; --.

6-1-98--3-31-00: --; 22 months.

4-1-00--1-31-02: 22 months; --.

Total: 38 months; 22 months.

_____END OF TABLE

Amy can exclude gain up to \$250,000. However, she cannot exclude the part of the gain equal to the depreciation she claimed, or should have claimed, for renting the house, as explained after Example 2.

<Page 17>

Example 2. William owned and used a house as his main home from 1996 through 1999. On January 1, 2000, he moved to another state. He rented his house from that date until April 30, 2002, when he sold it. During the 5-year period ending on the date of sale (May 1, 1997-April 30, 2002), William owned and lived in the house for 32 months (more than 2 years). He can exclude gain up to \$250,000. However, he cannot exclude the part of the gain equal to the depreciation he claimed, or should have claimed, for renting the house, as explained next.

Depreciation after May 6, 1997. If you were entitled to take depreciation deductions because you used your home for business purposes or as rental property, you cannot exclude the part of your gain equal to any depreciation allowed or allowable as a deduction for periods after May 6, 1997. This gain is reported on Form 4797. If you can show by adequate records or other evidence that the depreciation deduction allowed was less than the amount allowable, the amount you cannot exclude is the amount allowed.

Non-residential use within the home. If the part of your property used for non-residential purposes is within your home, such as a room used as a home office for a

business, you are treated as satisfying the use test for the entire property for purposes of the exclusion whether or not you were entitled to claim any depreciation deductions. No allocation of basis and amount realized from the sale is required, but the gain subject to exclusion does not include any gain that must be reported on Form 4797 because of depreciation deductions allowed or allowable after May 6, 1997. See Property used partly as your home and partly for business or rental during the year of sale, later.

Example. Ray sold his main home in 2002 at a \$30,000 gain. He meets the ownership and use tests to exclude the gain from his income. However, he used part of the home for business in 2001 and claimed \$500 depreciation. He can exclude \$29,500 (\$30,000-\$500) of his gain. He has a taxable gain of \$500 that must be reported on Form 4797.

Property used partly as your home and partly for business or rental during the year of sale. In the year of sale you may have used part of your property as your home and part of it for business or to produce income. Examples are:

- A working farm on which your house was located,
- An apartment building in which you lived in one unit and rented the others, or
- A store building with an upstairs apartment in which you lived

If you sell the entire property, you should consider the transaction as the sale of two properties. The sale of the part of your property used for business or rental is reported on Form 4797.

To determine the amounts to report on Form 4797, you must divide your selling price, selling expenses, and basis between the part of the property used for business or rental and the part used as your home. In the same way, if you qualify to exclude any of the gain on the business or rental part of your home, also divide your maximum exclusion between that part of the property and the part used as your home. If you want to use Worksheet 2 (shown earlier) to figure your exclusion and taxable gain from each part, fill out a separate Worksheet 2 (Part 2) for each. Excluding gain on the business or rental part of your home. You generally can exclude gain on the part of your home used for business or rental if you owned and lived in that part of the home for at least 2 years during the 5-year period ending on the date of the sale. If you used a separate Worksheet 2 (Part 2) to figure the exclusion for the business or rental part, do not fill out lines 10 and 11 of that Worksheet 2. Fill it out only through line 9. Then fill out Form 4797. Enter the exclusion for the business or rental part on Form 4797 as explained in the Form 4797 instructions. (Also see Example, below.) If you use Part IV of Schedule D (Form 1040) to figure your tax, first fill out the Unrecaptured Section 1250 Gain Worksheet in the Schedule D instructions.

Example. You sold your home on November 1, 2002. You had bought the home in 1992 and had owned and lived in it the entire 5-year period ending on the date of sale. For the first 2-1/2 years of that period, you used the entire house as your main home. For the last 2-1/2 years, you used 3/4 (75%) of the house as your main home and 1/4 (25%) of the house for business. Your records show:

Purchase price: \$80,000

Depreciation (on business part; all after 5-7-1997): \$1,363

Selling price: \$160,000

Selling expenses: \$10,000

Because you meet the ownership and use tests for the entire house, you can claim the exclusion for both the home and business parts. You start by finding the adjusted basis of each part. You determine that three-fourths (75%) of your purchase price was for the part used as your home; one-fourth (25%) was for the part used for business.

Note: In this table, columns follow each other in this order: Entry:
Personal (3/4); Business (1/4). Purchase price: \$60,000; \$20,000.
Minus--Depreciation: \$0; \$1,363.
Adjusted basis: \$60,000; \$18,637.
_____END OF TABLE

Next, you figure the gain on each part, dividing your selling price and selling expenses between the two parts.

Note: In this table, columns follow each other in this order: Entry:
Personal (3/4); Business (1/4). Selling price: \$120,000; \$40,000.
Minus--Selling expenses: \$7,500; \$2,500.
Total: \$112,500; \$37,500.
Minus--Adjusted basis: \$60,000; \$18,637.
Gain: \$52,500; \$18,863.
_____END OF TABLE

Then, to figure your taxable gain and exclusion on each part, you decide to fill out a separate Worksheet 2 (Part 2)

<Page 18>

for each part, dividing your maximum exclusion between the two parts. You are single, so the maximum exclusion is \$250,000.

Part 2--Exclusion and Taxable Gain. 6) Depreciation allowed or allowable after May 6, 1997: \$0; \$1,363.

7) Subtract line 6 from gain figured above: \$52,500; \$17,500.

8) Maximum exclusion: \$187,500; \$62,500.

9) Exclusion (Smaller of line 7 or line 8): \$52,500; \$17,500.

10) Taxable gain (gain figured above minus line 9): \$0; *

11) Smaller of line 6 or line 10: \$0; *

* Lines 10 and 11 do not need to be filled out for the business part.

Do not report the gain from the part used as your home, because you can exclude all of it. You report the gain from the business part (\$18,863) in Part III of Form 4797. You enter your exclusion (\$17,500) on line 2 of Form 4797. Your taxable gain from the business part is \$1,363 (\$18,863 minus \$17,500).

Special Situations

The situations that follow may affect your exclusion.

Expatriates. You cannot claim the exclusion if the expatriation tax applies to you. The expatriation tax applies to U.S. citizens who have renounced their citizenship (and long-term residents who have ended their residency) if one of their principal purposes was to avoid U.S. taxes. See chapter 4 of Publication 519, U.S. Tax Guide for Aliens, for more information about expatriation tax.

Home destroyed or condemned. If your home was destroyed or condemned, any gain (for example, because of insurance proceeds you received) qualifies for the exclusion.

Any part of the gain that cannot be excluded (because it is more than the limit) may be postponed under the rules explained in:

-- Publication 547, in the case of a home that was destroyed, or

-- Chapter 1 of Publication 544, in the case of a home that was condemned.

Sale of remainder interest. Subject to the other rules in this publication, you can choose to exclude gain from the sale of a remainder interest in your home. If you

make this choice, you cannot choose to exclude gain from your sale of any other interest in the home that you sell separately.

Exception for sales to related persons. You cannot exclude gain from the sale of a remainder interest in your home to a related person. Related persons include your brothers and sisters, half-brothers and half-sisters, spouse, ancestors (parents, grandparents, etc.), and lineal descendants (children, grandchildren, etc.). Related persons also include certain corporations, partnerships, trusts, and exempt organizations.

Reporting the Gain

Do not report the 2002 sale of your main home on your tax return unless:

- You have a gain and you do not qualify to exclude all of it, or
- You have a gain and choose not to exclude it.

If you have any taxable gain on the sale of your main home that cannot be excluded, report the entire gain realized (line 5 of Worksheet 2) on Schedule D (Form 1040). Report it on line 1 or line 8 of Schedule D, depending on how long you owned the home. If you qualify for an exclusion (line 9 of Worksheet 2), show it on the line directly below the line on which you report the gain. Write "Section 121 exclusion" in column (a) of that line and show the amount of the exclusion in column (f) as a loss (in parentheses).

If you used the home for business or to produce rental income during the year of sale, you must use Form 4797 to report the sale of the business or rental part (or the sale of the entire property if used entirely for business or rental in that year). See Business Use or Rental of Home, earlier.

Installment sale. Some sales are made under arrangements that provide for part or all of the selling price to be paid in a later year. These sales are called "installment sales." If you finance the buyer's purchase of your home yourself, instead of having the buyer get a loan or mortgage from a bank, you probably have an installment sale. You may be able to report the part of the gain you cannot exclude on the installment basis.

Use Form 6252, Installment Sale Income, to report the sale. Enter your exclusion (line 9 of Worksheet 2) on line 15 of Form 6252.

Seller-financed mortgage. If you sell your home and hold a note, mortgage, or other financial agreement, the payments you receive generally consist of both interest and principal. You must report the interest you receive as part of each payment separately as interest income. If the buyer of your home uses the property as a main or second home, you must also report the name, address, and social security number (SSN) of the buyer on line 1 of either Schedule B (Form 1040) or Schedule 1 (Form 1040A). The buyer must give you his or her SSN and you must give the buyer your SSN. Failure to meet these requirements may result in a \$50 penalty for each failure. If you or the buyer does not have and is not eligible to get an SSN, see the next discussion.

Individual taxpayer identification number (ITIN). If either you or the buyer of your home is a nonresident or

<Page 19>

resident alien who does not have and is not eligible to get an SSN, the IRS will issue you (or the buyer) an ITIN. To apply for an ITIN, file Form W-7, Application for IRS Individual Taxpayer Identification Number, with the IRS.

If you have to include the buyer's SSN on your return and the buyer does not have and cannot get an SSN, enter the buyer's ITIN. If you have to give an SSN to the buyer and you do not have and cannot get one, give the buyer your ITIN.

An ITIN is for tax use only. It does not entitle the holder to social security benefits or change the holder's employment or immigration status under U.S. law.
More information. For more information on installment sales, see Publication 537, Installment Sales.

Illustrated Example

Emily White, a single person, bought a home in 1991. She lived in the home until May 31, 2000, when she moved out of the house and put it up for rent. Emily rented her home until May 31, 2001. She moved back into the house and lived there until she sold it on January 10, 2002.

Emily can exclude gain on the sale of her home because she owned and lived in the home for at least 2 years of the 5-year period ending on the date of the sale.

Emily's records show the following:

- 1) Original cost: \$50,000
- 2) Legal fees for title search: \$750
- 3) Back taxes paid for prior owner: \$1,500
- 4) Improvements (deck): \$2,000
- 5) Selling price: \$195,000
- 6) Commission and expenses of sale: \$15,000
- 7) Depreciation claimed after May 6, 1997: \$1,642

Emily uses Worksheet 1 to figure the adjusted basis of the home she sold (\$52,608). She uses Worksheet 2 to figure the gain on the sale (\$127,392) and the amount of her exclusion (\$125,750). Emily cannot exclude \$1,642, the part of her gain equal to the depreciation deduction claimed while the house was rented.

Emily reports her gain and exclusion in Part II of Schedule D (Form 1040). She enters \$1,642 on line 12 of the Unrecaptured Section 1250 Gain Worksheet in the Schedule D (Form 1040) instructions. She has no gains or losses from the sale of property other than the gain from the sale of her home so, after completing that worksheet, she also enters \$1,642 on line 19 of Schedule D. She then figures her tax using Part IV of Schedule D.

Emily's completed Worksheets 1 and 2 and the front page of her Schedule D appear on pages 18 and 19. Page 2 of Schedule D and her Unrecaptured Section 1250 Gain Worksheet are not shown.

<Page 20>

Worksheet 1. Adjusted Basis of Home Sold

Caution: See if any of the situations listed in Table 1 apply to you before you use this worksheet.

1. Enter the purchase price of the home sold. If you filed Form 2119 when you originally acquired that home to postpone gain on the sale of a previous home before May 7, 1997, enter the adjusted basis of the new home from that Form 2119:
\$50,000
2. Seller paid points for home bought after 1990. (See Seller-paid points.) Do not include any seller-paid points you already subtracted to arrive at the amount entered on line 1 above: ----
3. Subtract line 2 from line 1: \$50,000
4. Settlement fees or closing costs. See Settlement fees or closing costs. If line 1 includes the adjusted basis of the new home from Form 2119, go to line 6.
 - 4a. Abstract and recording fees: ----
 - 4b. Legal fees (including title search and preparing documents): \$750
 - 4c. Surveys: ----
 - 4d. Title insurance: ----

- 4e. Transfer or stamp taxes: ----
4f. Amounts that the seller owed that you agreed to pay (back taxes or interest, recording or mortgage fees, and sales commissions): \$1,500
4g. Other: ----
5. Add lines 4a through 4g: \$2,250
6. Cost of additions and improvements. Do not include any additions and improvements included on line 1 above: \$2,000
7. Special tax assessments paid for local improvements, such as streets and sidewalks: ----
8. Other increases to basis: ----
9. Add lines 3, 5, 6, 7, and 8: \$54,250
10. Depreciation, related to the business use or rental of the home, claimed (or allowable): \$1,642
11. Other decreases to basis (see Decreases to basis, earlier.): ----
12. Add lines 10 and 11: \$1,642
13. ADJUSTED BASIS OF HOME SOLD. Subtract line 12 from line 9. Enter here and on Worksheet 2, line 4: \$52,608

Worksheet 2. Gain (or Loss), Exclusion, and Taxable Gain

Part 1--Gain (or Loss) on Sale

1. Selling price of home: \$195,000
2. Selling expenses: \$15,000
3. Subtract line 2 from line 1: \$180,000
4. Adjusted basis of home sold (from Worksheet 1, line 13): \$52,608
5. Subtract line 4 from line 3. This is the gain (or loss) on the sale. If this is a loss, stop here: \$127,392

Part 2--Exclusion and Taxable Gain

6. Enter any depreciation allowed or allowable on the property for periods after May 6, 1997. If none, enter zero: \$1,642
7. Subtract line 6 from line 5. (If the result is less than zero, enter zero.): \$125,750
8. If you qualify to exclude gain on the sale, enter your maximum exclusion. (See Maximum Amount of Exclusion.) If you do not qualify to exclude gain, enter 0: \$250,000
9. Enter the smaller of line 7 or line 8. This is your exclusion: \$125,750
10. Subtract line 9 from line 5. This is your taxable gain. Report it as described under Reporting the Gain on page 16. If the amount on this line is zero, do not report the sale or exclusion on your tax return. If the amount on line 6 is more than zero, complete line 11: \$1,642
11. Enter the smaller of line 6 or line 10. Enter this amount on line 12 of the Unrecaptured Section 1250 Gain Worksheet in the instructions for Schedule D (Form 1040): \$1,642

<Page 21>

SCHEDULE D (Form 1040)

Capital Gains and Losses 2002

-- Attach to Form 1040.

-- See Instructions for Schedule D (Form 1040).

-- Use Schedule D-1 to list additional transactions for lines 1 and 8.

Name(s) shown on Form 1040: Emily White

Your social security number: 000-00-0000

Part I Short-Term Capital Gains and Losses--Assets Held One Year or Less

1(a) Description of property (Example: 100 sh. XYZ Co.): ----

1(b) Date acquired (Mo., day, yr.): ----
1(c) Date sold (Mo., day, yr.): ----
1(d) Sales price (see page D-5 of the instructions): ----
1(e) Cost or other basis (see page D-5 of the instructions): ----
1(f) Gain or (loss) Subtract (e) from (d): ----
2 Enter your short-term totals, if any, from Schedule D-1, line 2: (d) ---- (e) shaded
(f) ----
3 Total short-term sales price amounts. Add lines 1 and 2 in column (d): (d) ---- (e)
shaded (f) shaded
4 Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684,
6781, and 8824: (f) ----
5 Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts
from Schedule(s) K-1: (f) ----
6 Short-term capital loss carryover. Enter the amount, if any, from line 8 of your
2001 Capital Loss Carryover Worksheet: (f) (----)
7 Net short-term capital gain or (loss). Combine lines 1 through 6 in column (f): (f) -

Part II Long-Term Capital Gains and Losses--Assets Held More Than One Year

8(a) Description of property (Example: 100 sh. XYZ Co.): main home, section 121
exclusion
8(b) Date acquired (Mo., day, yr.): 9-3-91
8(c) Date sold (Mo., day, yr.): 1-10-02
8(d) Sales price (see page D-5 of the instructions): 180,000
8(e) Cost or other basis (see page D-5 of the instructions): 52,608
8(f) Gain or (loss) Subtract (e) from (d): 127,392, (125,750)
8(g) 28% rate gain or (loss) * (see instr. below): ----
* 28% rate gain or loss includes all "collectibles gains and losses" (as defined on
page D-6 of the instructions) and up to 50% of the eligible gain on qualified small
business stock (see page D-4 of the instructions).
9 Enter your long-term totals, if any, from Schedule D-1, line 9: (d) ---- (e) shaded
(f) ---- (g) ----
10 Total long-term sales price amounts. Add lines 8 and 9 in column (d): (d)
180,000 (e) shaded (f) shaded (g) shaded
11 Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and
long-term gain or (loss) from Forms 4684, 6781, and 8824: (f) ---- (g) ----
12 Net long-term gain or (loss) from partnerships, S corporations, estates, and
trusts from Schedule(s) K-1: (f) ---- (g) ----
13 Capital gain distributions. See page D-1 of the instructions: (f) ---- (g) ----
14 Long-term capital loss carryover. Enter in both columns (f) and (g) the amount, if
any, from line 13 of your 2001 Capital Loss Carryover Worksheet: (f) (----) (g) (----)
15 Combine column (g) of lines 8 through 14: (f) shaded (g) ----
16 Net long-term capital gain or (loss). Combine lines 8 through 14 in column (f): (f)
1,642 (g) shaded

Next: Go to Part III on the back.

For Paperwork Reduction Act Notice, see Form 1040 instructions.

<Page 22>

Real Estate and Transfer Taxes

When you sell your main home, treat real estate and transfer taxes on that home as
discussed in this section.

Real estate taxes. You and the buyer must deduct the real estate taxes on your home for the year of sale according to the number of days in the real property tax year that each owned the home.

-- You are treated as paying the taxes up to, but not including, the date of sale. You can deduct these taxes as an itemized deduction on Schedule A (Form 1040) in the year of sale. It does not matter what part of the taxes you actually paid.

-- The buyer is treated as paying the taxes beginning with the date of sale.

If the buyer paid your share of the taxes (or any delinquent taxes you owed), the payment increases the selling price of your home. The buyer adds the amount paid to his or her basis in the property.

Example. The tax on Dennis and Beth White's home was \$620 for the year. Their real property tax year was the calendar year, with payment due August 1. They sold the home on May 7. Dennis and Beth are considered to have paid a proportionate share of the real estate taxes on the home even though they did not actually pay them to the taxing authority.

Dennis and Beth owned their home during the real property tax year for 126 days (January 1 to May 6, the day before the sale). They figure their deduction for taxes as follows. 1. Enter the total real estate taxes for the real property tax year: \$620.

2. Enter the number of days in the real property tax year that you owned the property: 126.

3. Divide line 2 by 365: .345.

4. Multiply line 1 by line 3. This is your deduction. Enter it on line 6 of Schedule A (Form 1040): \$214. Since the buyers paid all of the taxes, Dennis and Beth also include the \$214 in the home's selling price. The buyers add the \$214 to their basis in the home. The buyers can deduct \$406 (\$620 minus \$214), the taxes for the part of the year they owned the home.

Form 1099-S. If the person responsible for closing the sale (generally the settlement agent) must file Form 1099-S, the information reported on the form to you and the IRS must include (in box 5) the part of any real estate tax that the buyer can deduct. If you actually paid the taxes for the year of sale, you must subtract the amount shown in box 5 of Form 1099-S from the amount you paid. The result is the amount you can deduct.

More information. For more information about real estate taxes, see Publication 530. Transfer taxes. You cannot deduct transfer taxes, stamp taxes, and other incidental taxes and charges on the sale of a home as itemized deductions. However, if you pay these amounts as the seller of the property, they are expenses of the sale and reduce the amount you realize on the sale. If you pay these amounts as the buyer, include them in your cost basis of the property.

Recapture of Federal Subsidy

If you financed your home under a federally subsidized program (loans from tax-exempt qualified mortgage bonds or loans with mortgage credit certificates), you may have to recapture all or part of the benefit you received from that program when you sell or otherwise dispose of your home. You recapture the benefit by increasing your federal income tax for the year of the sale. You may have to pay this recapture tax even if you can exclude your gain from income under the rules discussed earlier; that exclusion does not affect the recapture tax.

Loans subject to recapture rules. The recapture applies to loans that:

- 1) Came from the proceeds of qualified mortgage bonds, or
- 2) Were based on mortgage credit certificates. The recapture also applies to assumptions of these loans.

Federal subsidy benefit. If you received a mortgage loan from the proceeds of a tax-exempt bond, you received the benefit of a lower interest rate than was customarily

charged on other mortgage loans. If you received a mortgage credit certificate with your mortgage loan, you were able to reduce your federal income taxes by a mortgage interest tax credit. Both of these benefits are federal mortgage subsidies. Sale or other disposition. The sale or other disposition of your home includes an exchange, involuntary conversion, or any other disposition.

For example, if you give away your home (other than to your spouse or ex-spouse incident to divorce), you are considered to have "sold" it. You figure your recapture tax as if you had sold your home for its fair market value on the date you gave it away.

When the recapture applies. The recapture of the federal mortgage subsidy applies only if you meet both of the following conditions.

- 1) You sell or otherwise dispose of your home:
 - a) At a gain, and
 - b) During the first 9 years after the date you closed your mortgage loan.

<Page 23>

- 2) Your income for the year of disposition is more than that year's adjusted qualifying income for your family size for that year (related to the income requirements a person must meet to qualify for the federally subsidized program).
When recapture does not apply. The recapture does not apply if any of the following situations apply to you:

- Your mortgage loan was a qualified home improvement loan of not more than \$15,000,
- The home is disposed of as a result of your death,
- You dispose of the home more than 9 years after the date you closed your mortgage loan,
- You transfer the home to your spouse, or to your former spouse incident to a divorce, where no gain is included in your income,
- You dispose of the home at a loss,
- Your home is destroyed by a casualty, and you repair it or replace it on its original site within 2 years after the end of the tax year when the destruction happened, or
- You refinance your mortgage loan (unless you later meet the conditions listed previously under When the recapture applies).

Notice of amounts. At or near the time of settlement of your mortgage loan, you should receive a notice that provides the federally subsidized amount and other information you will need to figure your recapture tax.

How to figure and report the recapture. The recapture tax is figured on Form 8828. If you sell your home and your mortgage loan is subject to the recapture rules, you must file Form 8828 even if you do not owe a recapture tax. Attach Form 8828 to your Form 1040. For more information, see Form 8828 and its instructions.

How To Get Tax Help

You can get help with unresolved tax issues, order free publications and forms, ask tax questions, and get more information from the IRS in several ways. By selecting the method that is best for you, you will have quick and easy access to tax help.

Contacting your Taxpayer Advocate. If you have attempted to deal with an IRS problem unsuccessfully, you should contact your Taxpayer Advocate.

The Taxpayer Advocate represents your interests and concerns within the IRS by protecting your rights and resolving problems that have not been fixed through normal channels. While Taxpayer Advocates cannot change the tax law or make a

technical tax decision, they can clear up problems that resulted from previous contacts and ensure that your case is given a complete and impartial review.

To contact your Taxpayer Advocate:

- Call the Taxpayer Advocate at 1-877-777-4778.
- Call, write, or fax the Taxpayer Advocate office in your area.
- Call 1-800-829-4059 if you are a TTY/TDD user.

For more information, see Publication 1546, The Taxpayer Advocate Service of the IRS.

Free tax services. To find out what services are available, get Publication 910, Guide to Free Tax Services. It contains a list of free tax publications and an index of tax topics. It also describes other free tax information services, including tax education and assistance programs and a list of TeleTax topics.

Personal computer. With your personal computer and modem, you can access the IRS on the Internet at www.irs.gov. While visiting our web site, you can:

- See answers to frequently asked tax questions or request help by e-mail.
- Download forms and publications or search for forms and publications by topic or keyword.
- Order IRS products on-line.
- View forms that may be filled in electronically, print the completed form, and then save the form for recordkeeping.
- View Internal Revenue Bulletins published in the last few years.
- Search regulations and the Internal Revenue Code.
- Receive our electronic newsletters on hot tax issues and news.
- Learn about the benefits of filing electronically (IRS e-file).
- Get information on starting and operating a small business.

You can also reach us with your computer using File Transfer Protocol at [ftp.irs.gov](ftp://ftp.irs.gov).

TaxFax Service. Using the phone attached to your fax machine, you can receive forms and instructions by calling 703-368-9694. Follow the directions from the prompts. When you order forms, enter the catalog number for the form you need. The items you request will be faxed to you.

For help with transmission problems, call the FedWorld Help Desk at 703-487-4608.

<Page 24>

Phone. Many services are available by phone.

- Ordering forms, instructions, and publications. Call 1-800-829-3676 to order current and prior year forms, instructions, and publications.
 - Asking tax questions. Call the IRS with your tax questions at 1-800-829-1040.
 - Solving problems. Take advantage of Everyday Tax Solutions service by calling your local IRS office to set up an in-person appointment at your convenience. Check your local directory assistance or www.irs.gov for the numbers.
 - TTY/TDD equipment. If you have access to TTY/TDD equipment, call 1-800-829-4059 to ask tax questions or to order forms and publications.
 - TeleTax topics. Call 1-800-829-4477 to listen to pre-recorded messages covering various tax topics. Evaluating the quality of our telephone services. To ensure that IRS representatives give accurate, courteous, and professional answers, we use several methods to evaluate the quality of our telephone services. One method is for a second IRS representative to sometimes listen in on or record telephone calls. Another is to ask some callers to complete a short survey at the end of the call.
- Walk-in. Many products and services are available on a walk-in basis.
- Products. You can walk in to many post offices, libraries, and IRS offices to pick up certain forms, instructions, and publications. Some IRS offices, libraries, grocery

stores, copy centers, city and county governments, credit unions, and office supply stores have an extensive collection of products available to print from a CD-ROM or photocopy from reproducible proofs. Also, some IRS offices and libraries have the Internal Revenue Code, regulations, Internal Revenue Bulletins, and Cumulative Bulletins available for research purposes.

-- Services. You can walk in to your local IRS office to ask tax questions or get help with a tax problem. Now you can set up an appointment by calling your local IRS office number and, at the prompt, leaving a message requesting Everyday Tax Solutions help. A representative will call you back within 2 business days to schedule an in-person appointment at your convenience.

Mail. You can send your order for forms, instructions, and publications to the Distribution Center nearest to you and receive a response within 10 workdays after your request is received. Find the address that applies to your part of the country.

-- Western part of U.S.:

Western Area Distribution Center
Rancho Cordova, CA 95743-0001

-- Central part of U.S.:

Central Area Distribution Center
P.O. Box 8903
Bloomington, IL 61702-8903

-- Eastern part of U.S. and foreign addresses:

Eastern Area Distribution Center
P.O. Box 85074
Richmond, VA 23261-5074

CD-ROM for tax products. You can order IRS Publication 1796, Federal Tax Products on CD-ROM, and obtain:

-- Current tax forms, instructions, and publications.

-- Prior-year tax forms and instructions.

-- Popular tax forms that may be filled in electronically, printed out for submission, and saved for recordkeeping.

-- Internal Revenue Bulletins.

The CD-ROM can be purchased from National Technical Information Service (NTIS) by calling 1-877-233-6767 or on the Internet at <http://www.irs.gov/cdorders>. The first release is available in early January and the final release is available in late February.

CD-ROM for small businesses. IRS Publication 3207, Small Business Resource Guide, is a must for every small business owner or any taxpayer about to start a business. This handy, interactive CD contains all the business tax forms, instructions and publications needed to successfully manage a business. In addition, the CD provides an abundance of other helpful information, such as how to prepare a business plan, finding financing for your business, and much more. The design of the CD makes finding information easy and quick and incorporates file formats and browsers that can be run on virtually any desktop or laptop computer.

It is available in March. You can get a free copy by calling 1-800-829-3676 or by visiting the website at www.irs.gov/smallbiz.

<Page 25>

Index

To help us develop a more useful index, please let us know if you have ideas for index entries. See "Comments and Suggestions" in the "Introduction" for the ways you can reach us.

A

Abandonment, 5
Address, change of, 2
Adjusted basis, 10
Amount realized, 4
Assistance (See Tax help)
B Basis, 5
Business use of home, 16, 17
C Casualties, 16, 18
Change in place of employment, 12, 13
Change of address, 2
Closing costs, 6
Comments, 3
Community property, 9
Condemned property, 16, 18
Construction, 7
Cooperative apartment, 7, 16
Cost as basis, 6
D Death, 13
Depreciation, 17
Disasters, 13
Divorce, 13
Divorced individuals:
Home received from spouse, 7
Home transferred to spouse, 5
Main home, 16
E Employment, change in status, 13
Example, illustrated, 19
Exclusion of gain, 12
Expatriates, 18
F Fair market value, 7
Federal subsidy, 22
Foreclosure, 5
Form:
1099-A, 5
1099-C, 5
1099-S, 4
4797, 17
8828, 23
Free tax services, 23
G Gain on sale:
Defined, 4
Exclusion of, 12
Gift, 7
H Health, 12, 13
Help (See Tax help)
How to report, 18
I Improvements, 10
Individual taxpayer identification number, 18
Individuals with disability, 16
Inheritance, 9
Installment sale, 18
Involuntary conversion, 13
J Joint owner, 5

- L Legal separation, 13
- Loss on sale, 4
- M Main home:
 - Defined, 3
 - More than one, 3
 - Married individuals:
 - Basis of home received from spouse, 7
 - Community property, 9
 - Deceased spouse, 16
 - Exclusion of gain, 16
 - Jointly owned home, 5
 - Main home after divorce, 16
 - Surviving spouse, basis of home, 9
 - Transfer of home to spouse, 5
 - Maximum exclusion, 12
 - More information (See Tax help)
 - More than one home, 3
 - Mortgage bonds, 22
 - Mortgage credit certificates, 22
 - Mortgage, seller-financed, 18
 - Multiple births, 13
- N New home, 3
- O Ownership and use tests, 15
- P Partly used as home, 17
- Payment by employer, 4
- Points, 2, 6
- Publications (See Tax help)
- Q Qualified individual, 13
- R Recapture of federal subsidy, 22
- Received from spouse, 7, 16
- Recordkeeping, 10
- Reduced maximum exclusion, 12
- Rental property, 16
- Repairs, 10
- Reporting the sale, 18
- Repossession, 5
- S Safe harbor, 13
- Sales to related persons, exception, 18
- Self-employment, change in status, 13
- Seller-financed mortgage, 18
- Selling expenses, 4
- Selling price, 4
- Separate returns, 5
- Settlement fees, 6
- Suggestions, 3
- T Tax help, 23
- Taxes:
 - Real estate, 6, 22
 - Transfer, 22
- Taxpayer Advocate, 23
- Terrorist attacks, 13
- Trade, 9
- Trading homes, 5

Transfer to/from spouse, 5, 7, 16
TTY/TDD information, 23
U Unemployment, 13
Unforeseen circumstances, 12, 13

<Page 26>

W Worksheet 1, 11, 20
Worksheet 2, 11, 20

<Page 27>

Tax Publications for Individual Taxpayers

See How To Get Tax Help for a variety of ways to get publications, including by computer, phone, and mail.

General Guides

1 Your Rights as a Taxpayer
17 Your Federal Income Tax (For Individuals)
334 Tax Guide for Small Business (For Individuals Who Use Schedule C or C-EZ)
509 Tax Calendars for 2003
553 Highlights of 2002 Tax Changes
910 Guide to Free Tax Services

Specialized Publications

3 Armed Forces' Tax Guide
54 Tax Guide for U.S. Citizens and Residents Aliens Abroad
225 Farmer's Tax Guide
378 Fuel Tax Credits and Refunds
463 Travel, Entertainment, Gift, and Car Expenses
501 Exemptions, Standard Deduction, and Filing Information
502 Medical and Dental Expenses
503 Child and Dependent Care Expenses
504 Divorced or Separated Individuals
505 Tax Withholding and Estimated Tax
508 Tax Benefits for Work-Related Education
514 Foreign Tax Credit for Individuals
516 U.S. Government Civilian Employees Stationed Abroad
517 Social Security and Other Information for Members of the Clergy and Religious Workers
519 U.S. Tax Guide for Aliens
520 Scholarships and Fellowships
521 Moving Expenses
523 Selling Your Home
524 Credit for the Elderly or the Disabled
525 Taxable and Nontaxable Income
526 Charitable Contributions
527 Residential Rental Property
529 Miscellaneous Deductions
530 Tax Information for First-Time Homeowners
531 Reporting Tip Income
533 Self-Employment Tax
534 Depreciating Property Placed in Service Before 1987

536 Net Operating Losses (NOLs) for Individuals, Estates, and Trusts
537 Installment Sales
541 Partnerships
544 Sales and Other Dispositions of Assets
547 Casualties, Disasters, and Thefts
550 Investment Income and Expenses
551 Basis of Assets
552 Recordkeeping for Individuals
554 Older Americans' Tax Guide
555 Community Property
556 Examination of Returns, Appeal Rights, and Claims for Refund
559 Survivors, Executors, and Administrators
561 Determining the Value of Donated Property
564 Mutual Fund Distributions
570 Tax Guide for Individuals With Income From U.S. Possessions
571 Tax-Sheltered Annuity Plans (403(b) Plans)
575 Pension and Annuity Income
584 Casualty, Disaster, and Theft Loss Workbook (Personal-Use Property)
587 Business Use of Your Home (Including Use by Day-Care Providers)
590 Individual Retirement Arrangements (IRA's)
593 Tax Highlights for U.S. Citizens and Residents Going Abroad
594 The IRS Collection Process
595 Tax Highlights for Commercial Fishermen
596 Earned Income Credit (EIC)
721 Tax Guide to U.S. Civil Service Retirement Benefits
901 U.S. Tax Treaties
907 Tax Highlights for Persons with Disabilities
908 Bankruptcy Tax Guide
911 Direct Sellers
915 Social Security and Equivalent Railroad Retirement Benefits
919 How Do I Adjust My Tax Withholding?
925 Passive Activity and At-Risk Rules
926 Household Employer's Tax Guide
929 Tax Rules for Children and Dependents
936 Home Mortgage Interest Deduction
946 How To Depreciate Property
947 Practice Before the IRS and Power of Attorney
950 Introduction to Estate and Gift Taxes
967 IRS Will Figure Your Tax
968 Tax Benefits for Adoption
969 Medical Savings Accounts (MSAs)
970 Tax Benefits for Education
971 Innocent Spouse Relief
972 Child Tax Credit (For Individuals Sent Here From the Form 1040 or 1040A Instructions)
1542 Per Diem Rates
1544 Reporting Cash Payments of Over \$10,000
1546 The Taxpayer Advocate Service of the IRS

Spanish Language Publications

1SP Derechos del Contribuyente

579SP C%omo Preparar la Declaraci%on de Impuesto Federal

594SP Comprendiendo el Proceso de Cobro

596SP Crédito por Ingreso del Trabajo

850 English-Spanish Glossary of Words and Phrases Used in Publications Issued by the Internal Revenue Service

1544SP Informe de Pagos en Efectivo en Exceso de \$10,000 (Recibidos en una Ocupación o Negocio)

Commonly Used Tax Forms

See How To Get Tax Help for a variety of ways to get forms, including by computer, fax, phone, and mail. For fax orders only, use the catalog number when ordering.

Form Number and Title: Catalog Number

1040 U.S. Individual Income Tax Return: 11320

Sch A & B Itemized Deductions & Interest and Ordinary Dividends: 11330

Sch C Profit or Loss From Business: 11334

Sch C-EZ Net Profit From Business: 14374

Sch D Capital Gains and Losses: 11338

Sch D-1 Continuation Sheet for Schedule D: 10424

Sch E Supplemental Income and Loss: 11344

Sch EIC Earned Income Credit: 13339

Sch F Profit or Loss From Farming: 11346

Sch H Household Employment Taxes: 12187

Sch J Farm Income Averaging: 25513

Sch R Credit for the Elderly or the Disabled: 11359

Sch SE Self-Employment Tax: 11358

1040A U.S. Individual Income Tax Return: 11327

Sch 1 Interest and Ordinary Dividends for Form 1040A Filers: 12075

Sch 2 Child and Dependent Care Expenses for Form 1040A Filers: 10749

Sch 3 Credit for the Elderly or the Disabled for Form 1040A Filers: 12064

1040EZ Income Tax Return for Single and Joint Filers With No Dependents: 11329

1040-ES Estimated Tax for Individuals: 11340

1040X Amended U.S. Individual Income Tax Return: 11360

2106 Employee Business Expenses: 11700

2106-EZ Unreimbursed Employee Business Expenses: 20604

2210 Underpayment of Estimated Tax by Individuals, Estates, and Trusts: 11744

2441 Child and Dependent Care Expenses: 11862

2848 Power of Attorney and Declaration of Representative: 11980

3903 Moving Expenses: 12490

4562 Depreciation and Amortization: 12906

4868 Application for Automatic Extension of Time To File U.S. Individual Income Tax Return: 13141

4952 Investment Interest Expense Deduction: 13177

5329 Additional Taxes on Qualified Plans, (Including IRAs) and Other Tax-Favored Accounts: 13329

6251 Alternative Minimum Tax--Individuals: 13600

8283 Noncash Charitable Contributions: 62299

8582 Passive Activity Loss Limitations: 63704

8606 Nondeductible IRA's: 63966

8812 Additional Child Tax Credit: 10644

8822 Change of Address: 12081

8829 Expenses for Business Use of Your Home: 13232

8863 Education Credits: 25379

9465 Installment Agreement Request