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

Sale of a Principal Residence Exclusion Rules and Rental of foreign/ U.S. Properties

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The goal of this article is to provide a comprehensive checklist of information to consider prior to moving out of the U.S. or moving to the U.S., selling or renting out your principal residence, and how to handle this when filing a tax return. This article is not designed to teach you the required technical competence to perform self compliance; however, it will certainly arm you with the technical knowledge to determine if your U.S. Certified Public Accountant (CPA) tax preparer knows all that they should know to provide you with technically competent professional services.

Exclusion rules on Sale of a Principal Residence:

Under IRC Sec 121- Exclusion of Gain from Sale of Principal Residence- If the home is your "main home" or principal residence (defined by facts and circumstances test- where you live, where you spend most of your time, similar to domicile) in the five year window prior to sale you must have: 1) owned and 2) used or lived in the home for at least two years = 24 months = 730 days for both spouses to qualify for the $250,000 per spouse exclusion of gain on sale rule.

The two years for the owned and use test do not have to be the same two years within the five years prior to sale. Further the determination of "main home" is made on an annual basis, such that there may be multiple "main home" determinations in any five-year window.

The use test does not require 730 consecutive days of use, as long as there are 730 days in the corresponding five-year window and use may occur during periods of non-ownership.

Temporary absences (vacation) even if rented out are counted as periods of use.

This exclusion may only be used once every two years.

If the taxpayer(s) do not have the two years for both tests they will not qualify for the exclusion unless: they have one of three 'primary reasons' that includes: change in location of employment, health reasons or unforeseen circumstances. In such cases the exclusion is prorated by qualifying days over 730 days.

For each of the three 'primary reasons' the taxpayer would look at i) specific primary reason "safe harbors" and/ or ii) individual facts and circumstances for each of the primary reason, including such factors as: close in time, owned & used at time of specific primary reason, primary reason not reasonably foreseeable, and material change in impairment of financial ability to maintain, or use during ownership.

Safe harbors for change in location of employment (focal point of this article) (where employment includes new or continuing employment or self-employment) include where the change occurred during the period of ownership and use of the main home and the new place of employment is at least 50 miles farther from the home sold than was the former place of employment.

As such a U.S. nonresident alien who moves to the U.S. or a U.S. expatriate who moves out of the U.S. and continues to maintain their foreign/ U.S. main home subsequently renting it out and selling it years after moving to/ expatriating from the U.S., will still qualify under the change in location of employment primary reason as long as they have usage (and ownership) in the five-year window prior to sale.

Obviously, the main handicap for U.S. nonresidents/ U.S. expatriates is that although they usually meet the two-year test of ownership, they *do not* meet the two year test on use.

If the home is *not* the taxpayers "main home" or principal residence or the taxpayer does not meet the above tests and they have held the home for more than one year then the gain would be taxed at the current long term capital gain rate, which is currently 15% and maybe 20% for taxpayers in the 37% bracket.

Non-qualified use- In the calculation of the gain from the sale or exchange of the principal residence the pro-rata portion of the gain attributable to non-qualified use in tax years 2009 or later, where neither you nor your spouse used the property as a main home, within certain exceptions will not be excludable under the above rules

An exception, however, to the above is any portion of the 5-year window period ending on the date of the sale or exchange after the last date you or your spouse used the property as your main home. In practicality what this means is that if there is any rental use during the 5-year window prior to sale, this rental period use it is NOT considered non-qualified use and the gain would not have to be pro-rata apportioned between qualified and non-qualified use.

The sale of principal residence exclusion under IRC Sec. 121 and other above discussions are also applicable to U.S. nonresident aliens and non- U.S. principal residences and ‘main homes’.

Minimizing the Net Unexcluded Gain on Sale:

The key to minimizing your capital gain on sale subject to the U.S. long term capital gains tax rate, currently as above at 15% and maybe 20% for taxpayers in the new 37% bracket, is to minimize your net capital gain. The net capital gain is comprised of net proceeds less net cost or basis. The goal is minimizing net proceeds and maximizing net costs, the closer these two amounts come together, the smaller the capital gain.

Although gross proceeds and gross costs are readily determinable, the net amounts may be more elusive to calculate than evident. To do this you will need the HUD 1 (Housing Urban Development) closing and settlement statements- the HUD 1 was eliminated October 3, 2015 to be replaced by similar looking form standardized by the CFPB- (Consumer Financial Protection Bureau) called a “Closure Disclosure” Form- or the foreign equivalents of these documents from both purchase and sale.

To maximize the net cost or basis, the purchase price on the contract, you must add the closing and settlement costs- legal, mortgage recording tax, insurance, hazard, transfer tax, etc as per the HUD 1 or CFPB- Closure Disclosure- settlement statement to bump up the cost to your net costs on purchase. To that amount you would also add your, subsequent to purchase improvements and additions.

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

Maintaining your Principal Residence while Abroad/ in the U.S.- Non-Rental:

If you decide to maintain your U.S. or foreign residence while living abroad or while living in the U.S., the mortgage interest and real estate taxes (foreign real estate tax deductibility eliminated on Schedule A only- not rental Schedule E, and U.S. real estate taxes are limited to the SALT $10,000 deduction under TCJA 2017) are deductible in the year that they are paid on Schedule A of Form 1040. As U.S. resident aliens- U.S. citizens and U.S. permanent residents (green card holders) or those persons meeting the Substantial Presence Test (SPT), your worldwide income is 100% U.S. taxable as are your worldwide deductions 100% U.S. deductible.

Renting it out:

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

Additionally, depreciation is a mandatory U.S. deduction. Failing to claim depreciation results in you being deemed to have claimed it. For U.S. located rental properties the depreciation rate for residential properties is 27.5 years straight line, while for foreign properties the rate is 40 years straight line for properties placed into service prior to 1/1/2018. Under the TCJA 2017 legislation this new straight rate for foreign properties is effective for tax years 1/1/2018 forward is now 30 years straight-line

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

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

There is a special election IRC Sec. 469(j)(7) to treat the mortgage interest of a former principal residence rented out as in effect by-passing the passive activity rules, therefore in effect triggering a rental loss to the extent of the mortgage interest annual claim. This mortgage interest would be termed Qualified Residence Interest. However, these rules have come under recent IRS scrutiny and have been challenged and aggressively audited by the IRS ensuring that the home meets the Qualified Residence rules as delineated in IRC Sec. 121. Basically, the home must be your main home where one may not have more than one main home at any time and the determination depends on the facts and circumstances of each case. However, it stands that a rental that lasts for several years may indicate that the property is no longer a principal residence and, therefore may no longer qualify as Qualified Residence Interest eligible for the IRC Sec. 469(j)(7) election treatment. So at best this position may be taken in the initial years 1and 2 years, although it is rarely used like it used to be.

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