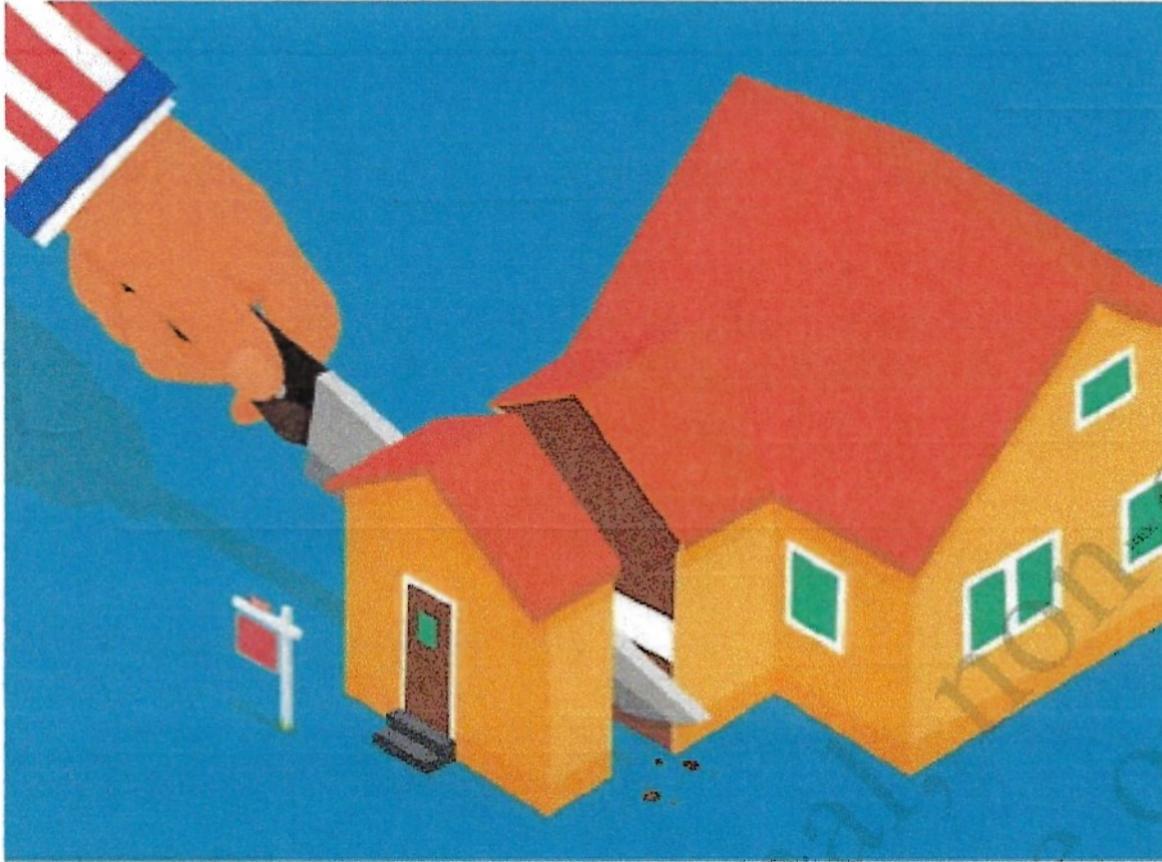


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Don't Miss Out on Big Tax Breaks When You Sell Your Home

TAX REPORT |

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A recent court case highlights the pitfalls that can cost sellers dearly

If you plan to sell a home, be sure to follow the rules on tax breaks. Losing them could put a big dent in the profits on one of your biggest in--vestments.

Jeffrey Pesarik just learned this the hard way, in a punishing loss in Tax Court.

The case involved the 2020 sale of Pesarik's home near Boston and another house in southern New Hampshire for a total of \$743,800. Pesarik, a real estate manager by profession, had bought the properties separately for a total of \$424,750 several years earlier. He claimed no tax was due on the sales because of longstanding tax breaks.

Tax Court Chief Judge Patrick Urda disagreed. He concluded Pesarik didn't deserve most of the tax breaks he claimed. As a result, he owes tax on \$255,281 of unreported 2020 income, plus a stiff penalty and interest. The amount due is unclear, but it's plenty.

Through his lawyer, Timothy Burke of Braintree, Mass., Pesarik declined to comment on the case while he considers an appeal.

This judgment is a cautionary tale for home sellers. It lays out what's required to get generous tax breaks on sales, and it also shows just how deep the IRS can dig if it suspects taxpayers are skirting the law.

(1)

The case “highlights the sharp reality of what can happen when home sellers have inadequate records and assume the IRS won’t ask questions,” says Eric Bronnenkant, a CPA who is head of tax at Edelman Financial Engines.

Let’s unpack what we can all learn from this case.

To get the home-seller exemption, you must live in the home.

Since the late 1990s, homeowners have been allowed an exemption of up to \$250,000 (single filers) and \$500,000 (joint filers) on profits on the sale of their principal residence.

Example: A married couple bought their home for \$400,000 years ago and sell it for \$850,000 today. They likely won’t owe tax on the sale because their \$450,000 gain is covered by the \$500,000 exemption. This couple could then buy another home, live in it, sell it and reap another \$500,000 exemption—and so on.

The catch? To get this benefit, the seller usually must live in the home for two of the five years preceding the sale. There are many nuances to this requirement; for more information, see IRS Publication 523.

Pesarik satisfied part of the two-year rule. He bought the home in Hull, Mass., in July 2018, and sold it in October 2020.

But was it his residence? The judge said while Pesarik owned the Hull property, he didn’t file income-tax returns in Massachusetts or have an in-state driver’s license. He used an Arizona license to verify his identity when he sold the home.

He also noted Pesarik’s creditcard bills went to a post-office box in Portsmouth, N.H., during much of this period. Upon examination, his utility usage didn’t show he was “definitively residing” at the Hull property during the time he owned it.

Based on this and other evidence, Urda ruled Pesarik didn’t qualify for the \$250,000 homesellers’ tax break. After a deduction for closing costs, he owed tax on \$137,083 from the sale of the Hull house.

Document expenses. Pesarik’s claim for tax breaks on his other property, a run-down house he improved in Wakefield, N.H., wasn’t successful either—because he didn’t keep good records.

The law allows owners of homes and other properties to lower taxes by raising their “cost basis” if they make capital improvements to them. Cost basis, an asset’s purchase price plus adjustments, is the starting point for measuring a taxable gain after a sale.

Say someone buys a property for \$200,000 and then invests \$100,000 in landscaping, a deck and other improvements. Several years later, the owner sells it for \$450,000. In that case, the seller’s cost basis could rise from \$200,000 to \$300,000, and the taxable gain could fall from \$250,000 to \$150,000. One caveat: Repairs don’t count as investments; see IRS Publication 523 again.

This tax break is useful to owners whose profit exceeds the \$250,000/\$500,000 exemption, or who aren’t eligible for it—perhaps because they are selling a second home or an investment property.

According to the opinion, Pesarik bought the Wakefield property for \$30,000 in 2016 and sold it in March, 2020 for \$187,000. He claimed he invested about \$82,000 in improvements, which could have lowered his taxable gain substantially.

But the judge disagreed because Pesarik’s records were a shambles. Among other things, his creditcard records for purchases at outlets like Home Depot and Lowe’s were vague. A spreadsheet he kept was no help either.

Result: The taxable gain on Pesarik’s Wakefield house was \$118,198, not \$55,799 as he claimed.

A ray of hope. Given Pesarik’s woes, homeowners might overlook a bit of good news. Despite the lack of good records, Urda allowed Pesarik to deduct about \$14,800 of credit-card expenses for the Wakefield property.

Taxpayers can thank entertainer George M. Cohan, who wrote the song known as “Yankee Doodle Dandy,” for this largess. It springs from a landmark 1930 case involving Cohan that allows taxpayers to deduct some expenses even if they don’t have receipts, as long as there’s a reasonable estimate. This is called “the Cohan rule,” and Urda cited it. It can help in a pinch.

Avoid penalties. The court ruled that in addition to owing back taxes and interest, Pesarik owed an accuracy penalty of 20% of his tax underpayment. The IRS or a court can impose this when a taxpayer hasn’t engaged in fraud but has been negligent or substantially understated the tax due. Pesarik did both, according to the decision.

Extenuating circumstance? Prove it. Pesarik argued he didn’t deserve the penalty because he had attention-deficit hyperactivity disorder and other ills. While tax rules can be flexible when taxpayers show reasonable cause for mistakes, the judge said Pesarik didn’t prove that his issues interfered with his ability to meet his tax obligations.

So homeowners, dot the i’s and cross the t’s when you sell—and be ready to show your work.

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