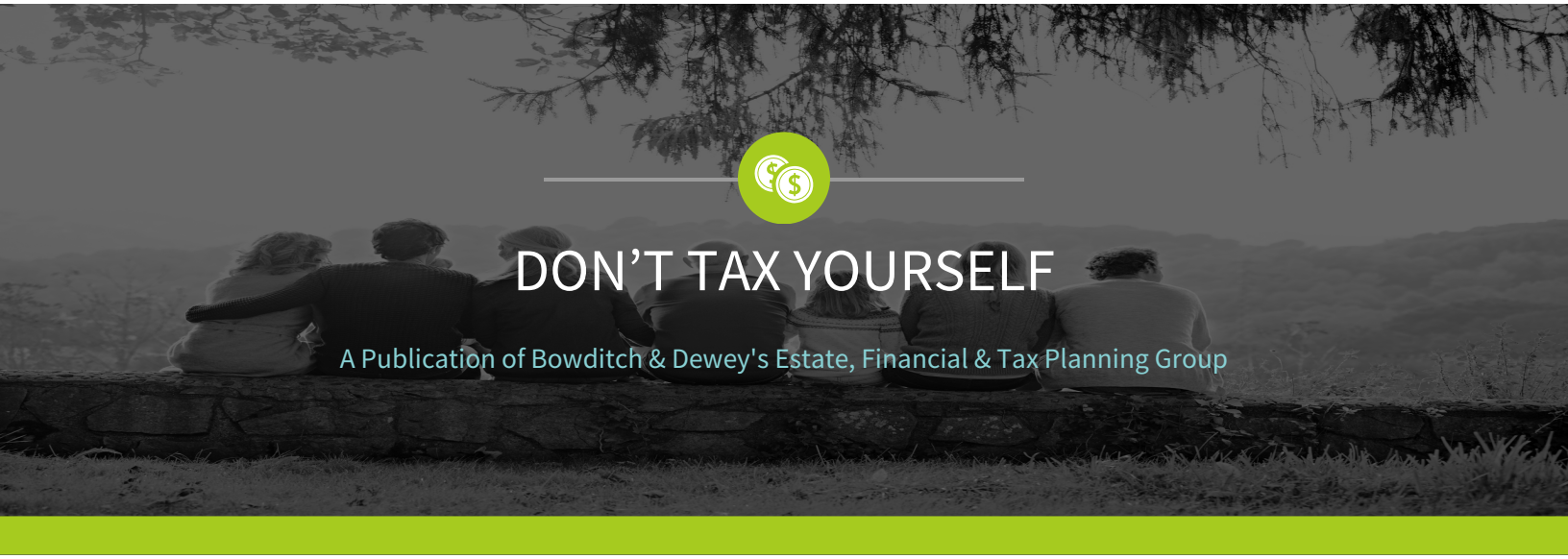

DON'T TAX YOURSELF

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When Home Sale Tax Breaks Go Wrong: Lessons Learned from the Pesarik Case

BY SCOTT C. CASHMAN • MARCH 26, 2026

A recent U.S. Tax Court decision (*Jeffrey Pesarik v. Commissioner of Internal Revenue*) highlights the importance of properly substantiating property tax basis and qualifying for the exclusion of capital gains on the sale of a principal residence.

In 2020, the taxpayer sold two properties:

- Wakefield Property (NH): Sold for $187,000
- Hull Property (MA): Sold for $556,800

The taxpayer did not report the sale of or gains from either property sale on his 2020 federal return. Based on third party reporting, the IRS issued a notice of deficiency in the amount of $271,774 and an accuracy-related penalty of $54,355, leading to a dispute over how much tax—and what penalties—the taxpayer owed.

THE WAKEFIELD PROPERTY: THE POWER OF ESTIMATES

In the Wakefield sale, the dispute was over the adjusted basis of the property. The taxpayer argued that renovation costs and closing fees significantly increased his basis, which would lower his taxable gain to approximately $55,799. The taxpayer produced monthly credit card and bank statements. The credit card statements described the transactions with varying amounts of specificity. In addition, evidence suggested the credit cards and banks accounts were used for expenditures related to four different properties. The Commissioner argued the taxpayer had not provided sufficient proof.

The Tax Court found the evidence insufficient for a precise calculation of capital improvements; however, the Tax Court did apply the **Cohan Rule** (from the landmark *Cohan v. Commissioner* case). This rule allows the court to estimate certain expenses if a taxpayer can prove they were incurred, even if exact receipts are missing. The court found the

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taxpayer's substantiation sufficient to allow an estimated increase in basis for the Wakefield property of 25% of the claimed expenses from the credit card and checks resulting in a capital gain of $118,198.

THE HULL PROPERTY: THE PRINCIPAL RESIDENCE HURDLE

The stakes were higher for the Hull property. The taxpayer attempted to exclude the entire gain under Internal Revenue Code Section 121, which allows taxpayers to exclude up to $250,000 (or $500,000 for joint filers) of gain from the sale of a principal residence.

To qualify, a taxpayer must generally have owned and used the property as a primary home for at least **two out of the five years** preceding the sale.

The taxpayer owned at least two other properties during the years in question. To prove use of the Hull property as a primary residence, the taxpayer offered the purchases on his credit cards and monthly utility bills for the Hull property. However, the taxpayer had an Arizona driver's license and did not file a Massachusetts income tax return for any of the years in question. In addition, the taxpayer did not offer any evidence consistent with a move to Hull (such as a moving company or buying furniture), nor did the taxpayer offer evidence of the time spent at each property.

In this instance, the court ruled against the taxpayer, concluding the taxpayer failed to demonstrate the property met these strict residency requirements and could not exclude the gain from the sale of the property.

KEY TAKEAWAYS FOR TAXPAYERS

- **Keep Your Receipts:** While the *Cohan* rule can sometimes save a taxpayer who has lost records, it is an uphill battle. Consistent documentation of renovations is the only way to guarantee a basis increase.
- **The 2-of-5 Year Rule is Strict:** If you are claiming a Section 121 exclusion of gains on a primary residence, ensure you have a clear paper trail (utility bills, voter registration, etc.) proving you physically lived in the home for the required 24 months.

This case serves as a reminder that the Tax Court is willing to be reasonable on basis estimates when some proof exists but will not budge on the statutory requirements for major tax exclusions.

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