WINTER NEWS

SALE OF RESIDENCE AFTER DEATH OF SPOUSE

Many of our clients are faced with the decision to sell their residence after the death of a spouse. This memo addresses in general terms the issues relating to potential capital gains taxes when the house is sold.

FIRST, THE GOOD NEWS...

Most of our clients will enjoy an exclusion from some or all of the capital gains taxes that would otherwise be due on the sale of their residence. This exclusion is generally available if the property sold was your principal residence for at least two of the five years before the sale.

The maximum exclusion per owner is $250,000. So, the exclusion for a couple can be as much as $500,000. This means that up to $500,000 of the amount of gain realized when the house is sold will not be subject to tax on that gain.

The amount of gain on the sale of the house is calculated by taking the net proceeds (including any mortgage payoff) and subtracting the owner's basis in the house. That's a lot of legalese that is best explained in this example:

What is Basis? Ray and Norma owned their house together. They bought it for $50,000 and have put $25,000 of structural improvements to increase its value. Their basis in the house is the total of those two investments, or $75,000. Because they own the house together, they each have half of that basis, or $37,500.

Why is Basis Important? Ray and Norma sell the house and their net proceeds after expenses of the sale are $175,000. When Ray and Norma sell the house, they must calculate their capital gain on the sale. In a broad sense, capital gain is your profit on the sale. In this case, the capital gain is the amount that Ray and Norma received from the sale ($175,000) less their basis ($75,000). So calculating basis is important in order to calculate the capital gain on a sale. If Ray and Norma file their taxes separately, they must calculate their gain separately. In this example, the individual gain would be one-half the proceeds ($87,500) less one-half the basis ($37,500). So, Ray and Norma would each have a gain of $50,000.

Since the gain that either Ray or Norma has realized is less than $250,000 for either one of them, and since they lived in the house for at least two of the last five years, they will not face any tax on the gain from the house sale.

MORE GOOD NEWS (AT LEAST FROM A TAX PERSPECTIVE)...

How Does Basis Change? When someone dies, the person(s) who inherit their property see a 'step-up' in basis. In our example, if Norma dies, Ray will receive an increase in the basis of the property that he inherited from Norma.

How Much is the Step-Up? The step-up in the basis of a property is whatever is needed to make the basis equal to the value of the property on the date of death. So, if Norma died when the property was worth $175,000, then the new basis in her half of the property is $87,500.

What About the Interest That Doesn't Step-up? Ray does not get a step-up on his half of the house.

What Does this Mean For Capital Gains After A Death? Now that Ray is sole owner of the house, his new basis is equal to his standard basis in his half ($37,500) plus the stepped-up basis in Norma's half ($87,500). So, Ray's new basis is $125,000. If Ray sells the house for $175,000, his capital gain would be $50,000 ($175,000 less $125,000). Ray can still exclude up to $250,000 of gain because the house was his principal residence, so Ray will not pay any tax.

How Does A Living Trust Affect Basis? The owner of a living trust is deemed to be the taxpayer for the purpose of calculating basis. What this means for Ray and Norma is that they will be treated as owners of the house even if the house is held in a living trust. The above calculations will not change provided that Norma's trust was revocable by Norma and Ray's trust was revocable by Ray.

How Does A Living Trust Affect Exclusion? Because Norma and Ray were deemed to be the owners of their living trust, they would still be entitled to the exclusion for gain on the sale of their principal residence while both of them were alive. Once Norma dies, this exclusion may still apply to her share of the residence in certain circumstances. However, the exclusion usually isn't necessary for Norma's share after her death because of the step-up in basis.