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Basic Estate Planning Fact Sheet Series

Sale of Residence

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For many without a family business, your major asset is your home. The great American dream of owning one's own home is often achieved by retirement years. Many will not consider selling the home or using up its equity during retirement. However, some prefer moving to a smaller place or to an apartment where maintenance is done by the landlord.

Some wish to pass on the home intact to a child or another heir. However, many homes are not passed on to someone in the family. This fact sheet will be of most interest to you if selling your home during your lifetime is a consideration. This fact sheet will also discuss ways to stay in your home while selling the future interest in your home. If you plan to pass on your home to an heir, pay particular attention to the next fact sheet in this series, titled "Nursing Home Dilemma."

Old Law

In the past, gain in value of your home accumulated or was deferred as long as you pur-

chased a home of equal or greater value than the previous one. However, we now have an even more favorable treatment of gain in value of personal residence for income tax calculation, for most.

Exclusion of Gain on Principal Residence

If you reside in a residence as your principal residence for two out of the preceding five years prior to a sale, a single filer will be able to exclude \$250,000 of gain (\$500,000 for joint filers) from income tax calculation when their home is sold. Generally, this benefit cannot be obtained more often than once every two years. This benefit replaces the prior two provisions: one that permitted the gain to be rolled into a new residence and the second that allowed a \$125,000 one time exclusion for taxpayers age 55 or older. The exclusion does not apply to sales of remainder interests to related parties, including for example, brothers, sisters, spouses, ancestors, or descendants.

For most, the gain enjoyed while living in one's home will not approach the \$250,000 (\$500,000 for joint filers) exclusion.

The present exclusion is much more liberal than the previous exclusion because not only is the dollar amount larger, but this exclusion can be used every two years whereas the earlier exclusion could be used only once per couple.

However, only the principal residence and surrounding "yard," not an entire farm, qualifies for the \$250,000 (\$500,000 for joint filers) exclusion of gain from income tax. Furthermore, rules to defer income taxes on the gain in the value of business (farm) property (like kind exchange rules) are much more stringent than the rules to exclude income taxes on the gain in value of your personal residence. Therefore, if the residence is part of farm or other business property, the residence and (farm) business property must be valued separately.

Transfer of property (sale, gift, inheritance) either triggers or defers taxes. Sale of appreciated property usually triggers income tax liability. Gifted property may be subject to gift tax but generally defers capital gain. Inheritance triggers the estate settlement costs discussed earlier. However, the sale of one's principal residence(s) will likely be tax free.

So You Sell Your Home, What Then?

Assume you can convert your home to cash, tax free. How do you avert estate settlement costs on the cash received from the sale of the house? Selling the home, then spending the proceeds during retirement, and any excess being given to children and/or grandchildren looks very good on paper to avoid taxes and estate settlement costs.

If the anticipated estate exceeds \$3,500,000 then it likely may be advisable to make yearly

gifts of \$13,000 per person per donee. However, if the estate is less than that depending on the year of death, the \$13,000 limit may not be of concern. Even if one plans to get rid of every penny, the trick is deciding how much is needed for retirement. Most will not get rid of all reserves, but every dollar not in your estate evades estate settlement charges. However, remember we are all living longer, so don't short yourself in your last years.

Gift to Children/Grandchildren

Giving extra cash for grandchildren's education or medical care may be appropriate. If tuition, hospital bills, etc., are paid directly to the institution, more can be gifted without reducing the federal or state estate tax exclusion. Because the financial needs of families are greatest when the family is the youngest, your children and grandchildren will likely benefit more from gifts now than the benefit derived from the same dollars passing through inheritance.

Buy Life Insurance

What if you sell your home, don't want the proceeds to be included in your estate, don't need the money, but don't want to give the money to others until you die. One option is to use proceeds from the sale of the house to purchase life insurance. The insurance company will make a profit and premium costs increase with the age of the insured; therefore, you may end up paying close to the face value of the policy in premium payments. However, life insurance can be set up so that the death settlement is not subject to estate settlement costs, including Ohio and federal estate taxes. Look at this option with an accountant or financial advisor. Savings in estate settlement costs may or may not offset the charges of the life insurance company.

Irrevocable Living Trust

Trusts have become increasingly popular. Let's consider some advantages and disadvantages of putting the proceeds of the sale of one's home in trust. Remember that there are different kinds of trusts and each is treated differently. But, just a few short notes seem appropriate concerning putting proceeds from the sale of a home into a trust. With testamentary trusts (those created by a will), cash will be treated as any other liquid asset. With a living trust, you may wish for a trust department at a bank to manage the cash, even though there will be a fee for doing so. Remember, others besides a trust department may be trustees, including family members. If the living trust is revocable, or you otherwise have control over the assets in the trust, Ohio and federal estate taxes will be assessed on most of the assets in the trust. For Ohio estate tax purposes, life insurance proceeds are not taxable if payable to a revocable trust. If the trust is set up as a living irrevocable trust, a gift may occur upon funding of the trust, thus triggering use of the unified credit if the gift exceeds \$13,000 per year or if the trust is not drafted in a special manner to allow it to qualify for annual exclusion purposes. Once the \$1 million federal exclusion amount for gifting is used up, gift tax may be due. Consult your accountant and attorney if considering gifts approaching \$1 million.

Sell Your Home But Live There The Rest of Your Life

Outright sale of your home or property while living is the simplest and may be the best option if the maintenance and upkeep of the home or property becomes a burden, financially or emotionally. This is often the case for the elderly or for those of poor health. However, many wish to retire in place and do not wish to move from their home. There are ways

to get cash from the equity in your home, but still live there the rest of your life. Options in getting cash from your home but living there the rest of your life are: 1) reverse mortgaging, or 2) selling only the remainder rights (retaining a life estate).

Reverse Mortgage

Reverse mortgage means you own the home but that you mortgage your home to someone else. A reverse mortgage is very similar to the increasingly popular "home equity loan." In a home equity loan you "mortgage" only part of the value of your home, but with a reverse mortgage usually all of the home is mortgaged. Part of the agreement for a reverse mortgage is usually that you can stay there the rest of your life. The buyer of a reverse mortgage usually does not pay you in one lump sum, but pays you over a long period of time, usually in equal payments during the rest of your life (annuitized payments). Sometimes the mortgage purchaser pays you an annuity for only a set period of time. As payments are made, the owner's equity in the home reduces, but for annuities, payments continue even if more is paid than the home is worth. If the owner vacates the home or dies before expected, the heir(s) or owner is paid the remaining equity.

A reverse mortgage may be considered if the equity in the home will be of more benefit to the owner(s) while living, than to the children or heirs after the owners die. The reverse mortgage provides income to the owner(s) to live at a higher standard of living during retirement, and can reduce estate settlement costs if the cash payments are spent or given so their value is not included in the estate.

However, with a reverse mortgage there will be less or no equity in the estate from the home to be passed on to heirs.

Life Estate

Another option to reverse mortgage would be to sell only the remainder interest of the home while retaining the life interest or owning the property as a life estate only. This also allows the owner of the life estate to live their life out in their home while using the equity in their home for retirement or other purposes. When the owner(s) sell the remainder rights but retain the life estate, they retain the right to live in the house or use the property as they wish for as long as they live. However, upon death, the home or property automatically goes to the owner of the remainder interest. Owning a life estate and selling remainder rights may be a better option than the reverse mortgage if the owner wishes to stay in the home, but desires an up front, lump sum payment rather than spreading out payments over a period of time. However, be cautious of giving remainder rights to relatives.

Often considered is retaining the right to live out one's life in one's home (life interest), but instead of selling the remainder rights, to gift them to the would be heirs. This seems simple and straight forward at first brush, but let us consider several potential pitfalls.

First, if the remainder interest is given to would-be heirs, and the life estate is retained, the total value of the property is included in the donor's estate. Therefore, doing this seldom saves taxes.

Second, the person with the life estate is granted only the use and benefits of the property for life. The person with the life estate cannot make major changes in the property which would greatly decrease its value. More importantly, the person may not be able to use the property as collateral for a loan. This may be especially problematic for a son or daughter who are gifted only a life estate in a farm. In general, life estates allow for little flexibility and need to be critically evaluated by estate planning professionals.

If tax savings is an issue, you may want to consider a qualified personal residence trust, where you retain the right to live in the residence for a term of years and at the end of the term of years you would need to pay rent to the beneficiaries you name in the trust.

Conclusion

Selling or giving one's home is certainly not for everyone. However, because of the exclusion of capital gains of \$250,000 (\$500,000 for joint filers) on principal residences, it is possible to sell one's home and not pay income tax on the capital gain. If the elderly homeowner needs the money for retirement expenses and will benefit more from the equity in the home than will the heirs, sale of the home outright, a reverse mortgage, or keeping the life interest but selling the remainder rights should be considered. The later two will allow the homeowner to reside in the home the rest of their life.

These fact sheets should in no manner be considered as a replacement for consulting with estate planning professionals, nor should the general principles in these fact sheets be applied to specific situations without consulting with an attorney.

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Your Response

Fact Sheet 9

1. Joe and Mary purchased their home 50 years ago for \$20,000 and just now sold their home for \$200,000. They file a joint return and have lived in the home during their ownership. Will any of the gain cause increased income taxes?

_____ Yes

_____ No

2. Elizabeth is a widow who paid \$15,000 to Wooster College for tuition and room and board for her granddaughter. Will her federal estate tax exclusion be reduced?

_____ Yes

_____ No

3. Elizabeth is a widow who sold her home for \$200,000. Name several of her options to avert estate settlement costs being assessed on the \$200,000.

Options to get cash from your home, but still live there the rest of your life are reverse mortgaging and selling remainder rights while retaining a life estate.

4. Which of the above generally gives monthly payments?
5. Which of the above generally gives an up front, lump sum payment but often for an amount less than one would receive for outright sale of the home?

Answers

Fact Sheet 9

1. Joe and Mary purchased their home 50 years ago for \$20,000 and just now sold their home for \$200,000. They file a joint return and have lived in the home during their ownership. Will any of the gain cause increased income taxes?

Yes

No

No, the total gain is less than the \$500,000 exclusion available. Total gain is: \$180,000 sale price minus \$20,000 basis = \$180,000.

2. Elizabeth is a widow who paid \$15,000 to Wooster College for tuition and room and board for her granddaughter. Will her federal estate tax exclusion be reduced?

Yes

No

No, even though only \$13,000 per person per year can be given before the federal estate tax

exclusion is reduced, if the contribution is given directly to an institution such as a university or hospital, there is no limit.

3. Elizabeth is a widow who sold her home for \$200,000. Name several of her options to avert estate settlement costs to be charged on the \$200,000.

- **spend the \$200,000 while living**
- **purchase life insurance with heirs as beneficiary**
- **gift away the \$200,000. If Elizabeth's estate is less than \$1 million, she doesn't need to concern herself with the \$13,000 per person per year limit.**

If the \$200,000 is held by Elizabeth upon her death, it will add to the total amount of her assets upon which estate settlement costs are calculated. If her estate is less than \$1 million she can certainly ignore the \$13,000 limit, but likely ignore it if less than \$3,500,000 and the gift is less than \$1,000,000. She can likely gift over \$13,000 per person per year and still have adequate federal estate tax exclusion remaining to avert federal estate taxes unless her estate is quite large.

Options to get cash from your home, but still live there the rest of your life are reverse mortgaging and selling remainder rights while retaining a life estate.

4. Which of the above generally gives monthly payments?

Reverse Mortgage

A reverse mortgage is the opposite of a regular mortgage. In a regular mortgage, the individual pays the institution. With a reverse mortgage, the institution pays the individual, generally on a monthly basis.

5. Which of the above generally gives an up front, lump sum payment but the payment is generally less than it would be for an outright sale?

Selling remainder rights while retaining a life estate.

If one sells remainder rights to a home or other property, they have sold the right to will it to another person when they die. This may be sold (usually paid all at once) or given. However, retaining the life estate gives the holder the right to the use of the property as long as they live.