# Tax changes affect estate planning and the selling of a home

This article describes the federal tax treatment of sales of principal residences and second homes in light of tax law changes set to take effect on Jan. 1.

**Current law**

Gain on the sale of a principal residence up to $250,000 ($500,000 for married couples) generally is excluded from income if the residence was used as a principal residence for two of the five years preceding sale. The gain exclusion does not apply to so-called "flips" — only one sale of one personal residence every two years qualifies.

Generally, the gain exclusion only applies to residences, or portions thereof, used as a personal dwelling unit. This exception does not apply, however, if the seller's nonqualifying use of the residence, as rental property, for example, preceded Jan. 1, 2009, or follows a period of use that would otherwise qualify the residence for the gain exclusion rule.

Taxpayers can still exclude a portion or all of the gain on the sale of a primary residence if (i) the taxpayer failed to own or use the property as a dwelling unit for the requisite two-year period or (ii) sold another residence within the two-year period preceding the sale in question, if (iii) the sale in question is deemed to be by reason of a change in place of employment, health or unforeseen circumstances.

Gain on the sale of a primary residence beyond the $250,000 (or $500,000 for married couples) exclusion constitutes long-term capital gain, taxed at a relatively low 15 percent rate.

Gain on the sale of a second home is also subject to the 15 percent long-term capital gains rate, but cannot be sheltered by the gain exclusion that applies to a sale of a primary residence.

**Changes coming in 2013**

Without congressional action, the Bush tax cuts will expire on Jan. 1. As part of the expiration of myriad other tax provisions, the long-term capital gains rate will generally increase to 20 percent next year. However, for property purchased after Dec. 31, 2000, and held for longer than five years, the long-term capital gains rate will only increase to 18 percent.

Included as a revenue-raiser in the Health Care and Education Reconciliation Act of 2010, Jan. 1 will also see the instatement of a 3.8 percent Medicare contribution tax. This tax will be imposed on investment income and capital gains for taxpayers earning more than $200,000 a year ($250,000 for married couples). The 3.8 percent tax does not apply to the portion of gain from the sale of a residence excluded from tax ($250,000 or $500,000 for married couples).

**Available strategies**

Steps can be taken (or not taken) to avoid the impact of the new changes. If you are selling a primary residence and will realize gain in excess of the exclusion amount or if you are selling a second home, accelerate the closing date for the sale before or on Dec. 31, if possible, to take advantage of the lower 2012 rates.

If you intend to pass the value you earn from a sale of your home or a second home to your family, depending on your other available assets, you may want to plan on holding the residence until your death. At death, the basis of the home will be "stepped up" in your estate, avoiding any income tax on the appreciation of your home between the date you purchased it and the date of your death.

For example, assume you are

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married and purchased a home in 1995 for $300,000 that is currently worth $1 million. Also assume that you have used the home as your primary residence. In 2012, the tax bill for selling the house would be $30,000 (15 percent x ($700,000 of total gain — $500,000 of gain exclusion)).

A 2013 sale, assuming your modified adjusted gross income exceeds $250,000, would result in a tax bill of $47,600 (20 percent x ($700,000 of total gain — $500,000 of gain exclusion) + 3.8 percent x ($700,000 — $500,000 of gain exclusion)).

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> *"If you die owning the home, however, the basis in the home is stepped up to its fair market value at the date of your death."*

stepped up to its fair market value at the date of your death. In the example described, if you died and your estate sold your home the day after your death, there would be no gain on the sale, and no income tax, because your estate would be treated as if it had purchased the home for $1 million.

The following examples illustrate the effect of the 2013 tax hikes and the effect of owning the home at death.

Example 1. Assume seller is married and buys a home in 1995 for $300,000 that she and her husband live in until Dec. 31, 2012, when the residence is sold for $1 million. The tax bill on the sale will be $30,000 (15 percent x ($700,000 of total gain — $500,000 of gain exclusion)).

Example 2. Assume the same facts, except the sale closed on Jan. 1, 2013. The tax bill will increase to $47,600 (20 percent x ($700,000 of total gain — $500,000 of gain exclusion) + 3.8 percent x ($700,000 of total gain — $500,000 of gain exclusion)).

Example 3. Assume the same facts as Example 2 except that the seller and her husband purchased the house in 2001. The tax bill will be $43,600 (18 percent x ($700,000 of total gain — $500,000 of gain exclusion) + 3.8 percent x ($700,000 of total gain — $500,000 of gain exclusion)).

Example 4. Assume the same facts as Example 2 except that the seller and her husband had willed their entire estates primarily to one another, that they both die and that the survivor's estate sells the residence in 2012 or 2013. Assuming the fair market value of the property at the survivor's death equals its $1 million purchase price, no tax results from the sale because the basis of the residence was stepped up to $1 million at death.

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