



Advanced Planning Strategies

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Dear Reader,

Election year politics are influencing the timing and substance of tax legislation. It appears to be acceptable to most legislators to extend some tax relief provisions that are set to expire at the end of the year. Specifically, the provisions for (1) relief against the marriage penalty, (2) the \$1,000 child credit, (3) the expanded 10 percent bracket, and (4) increased exemptions against the alternative minimum tax have broad support. These items may be considered piecemeal in separate bills. The key sticking point of any legislation is whether the tax relief provisions must be offset (in whole or in part) by tax increases or spending decreases. A business tax provision that is being considered is the extension of the \$100,000 current expensing limit under IRC Sec. 179 until 2007. Because there are many tax cuts scheduled to expire or “sunset” between 2004 and 2011, we expect to discuss this issue for some time into the future, regardless of the outcome of the November elections.

There is always talk about the complexity of the current tax system and potential alternatives--notably a consumption tax or sales tax. There are companion bills (HR 25 and S 1493) in Congress to eliminate the current tax system and introduce a national sales tax. The bill would create a 23 percent national sales tax in 2005. However, the rate is tax inclusive (i.e., there would be tax on the price including the tax) and the actual rate is near 30 percent. Of course, this type of dramatic overhaul would not receive serious consideration on a short-term timeframe (if ever), and there is significant debate among economists as to the sufficiency of the proposed rate.

The IRS responded to criticism of the burden created by tax legislation that caused automatic allocation of a donor's generation-skipping tax exemption (currently \$1.5 million) to certain gifts made to trusts that might benefit grandchildren or great-grandchildren. The proposed regulations (Prop. Treas. Reg. Sec. 26.2632-1) would permit a one-time election on a gift tax return to eliminate the application of the exemption to current and future gifts to the trust. The automatic allocation was intended to be a tax compliance simplification method, but it creates automatic allocation for certain gifts to trusts where allocation does not make sense. The proposed rules would remove the burden of a yearly gift tax return.

Knowledge is not power. Only knowledge in use is power.

PLANNING FOR THE SALE OF A PERSONAL RESIDENCE

The tax laws applicable to home sales raise a number of issues in planning for maximum tax efficiency when selling a home. In this letter we will cover several of these issues to help homeowners understand the proper strategies to avoid tax on these transactions.

BASIC RULES FOR THE HOME SALE EXCLUSION

Gain realized upon the sale of a principal residence will not be taxed except to the extent that the gain exceeds specified limits. The maximum amounts for the home sale exclusion are \$500,000 of gain for married taxpayers filing jointly and \$250,000 of gain for other taxpayers. Realized gain is essentially the amount by which the net proceeds from the sale of the home exceed the taxpayer's cost of purchasing and improving the home.

To qualify for this exclusion, the taxpayer must have both owned and used the home as a principal residence for periods aggregating 2 years or more during the 5-year period ending on the sale date. In the case of married taxpayers filing jointly, it is necessary for only one spouse to meet the ownership requirement to obtain the maximum \$500,000 exclusion (although both spouses must meet the use requirement). This means that for married couples, the ownership arrangement between the spouses will have no particular effect on the availability of the exclusion. For example, the same exclusion is available, regardless of whether only one spouse has ownership of the home or the spouses own the home jointly. If, however, only one spouse has occupied the home as a principal residence for 2 out of the prior 5 years, the maximum exclusion is \$250,000.

It is critical to understand that unlike the rollover provision under prior law, there is no longer a requirement that a taxpayer purchase a new residence to qualify for the home sale exclusion. Therefore, whether the taxpayer is trading down, trading up, or simply renting after the sale has no effect on the availability of the exclusion. The exclusion may be claimed more than once but generally not more than once every 2 years. It also doesn't matter whether the taxpayer has previously used the now repealed once-in-a-lifetime home sale exclusion for taxpayers aged 55 and over that existed under prior law. The once-in-a-lifetime requirement does not apply in any way to the current exclusion.

Any depreciation claimed with respect to the home after May 6, 1997, will reduce the amount of gain eligible for the exclusion. Gain equal to the amount of this depreciation will be taxed at a maximum long-term capital gains tax rate of 25 percent, unless the taxpayer's highest marginal rate of tax is lower. This occurs in cases where the home or a portion of it has been used for business or income-producing purposes, such as for a home office. Note that the IRS does not currently intend to disallow the home sale exclusion with respect to the value of the portion of a home used as a home office. The entire home will qualify for the exclusion, but any gain attributable to depreciation previously claimed for the business portion of the home will be taxed as just described.

REQUIREMENTS UNDER SPECIAL CIRCUMSTANCES

Taxpayers who reside in nursing homes or similar long-term care facilities may treat up to one year of their stay in such a facility as occupancy of the residence for purposes of the 2-year use requirement, so long as the taxpayer was physically or mentally incapable of self-care during his or her stay in the nursing home or other facility. This makes it easier for these taxpayers to qualify for the exclusion.

A reduced exclusion limit applies in cases where a home sale occurs as a result of a change in employment, or a change in health, and the ownership and use requirements are not fully met. In such cases, the maximum

allowable exclusion is reduced proportionately according to the degree to which the taxpayer falls short of the 2-year requirements.

Special rules apply to ease the qualification for the exclusion in cases involving divorced couples. For example, a spouse who receives a home pursuant to a divorce settlement may count the transferor spouse's ownership of the home for purposes of qualifying under the 2-year ownership rule when the transferee spouse sells the home. This is helpful in cases where the spouse receiving the home in a divorce settlement did not have an ownership interest in the home during the marriage.

TAX PLANNING IF YOU'RE TAKING THE PLUNGE

If a couple is planning to be married and one of them owns a home, it may be prudent to delay any sale of that home until after the couple marries and lives together in the home for at least 2 years. By doing so, they can raise the maximum amount of the exclusion from \$250,000 to \$500,000. If both individuals own a home and are planning to be married, a maximum \$250,000 exclusion would be available to each of them before their marriage for the sale of either home (or both homes). However, the maximum \$500,000 exclusion would be available only with respect to a home in which a married couple has occupied as a personal residence for the 2-out-of-5-year period. If one of the spouses sold a home just before the marriage and used the exclusion, the couple would have to wait at least 2 years before the full \$500,000 exclusion would be available for the other home.

Note that the home sale exclusion is available only for the taxpayer's principal residence. It does not apply to vacation homes or second homes. Therefore, any one taxpayer (whether an unmarried person or a married couple filing jointly) can have only one principal residence at any given time for exclusion purposes.

RENTING THE HOME PRIOR TO A SALE

Suppose the real estate market is soft in the taxpayer's neighborhood, or the taxpayer must vacate the home before the sale for employment, business, or personal reasons. Because the cost of maintaining two residences is generally not manageable, the taxpayer may wish to rent the home while it is for sale. As long as the home has been used by the taxpayer as a principal residence for 2 out of the 5 years prior to the sale, renting the home pending its sale will not disqualify the taxpayer for the exclusion, and it may provide additional tax benefits associated with rental use. Remember, however, that gain on the sale will be taxed to the extent of the depreciation claimed after May 6, 1997, as described above. If necessary, the taxpayer can move back into the home before it is sold for sufficient time to qualify under the 2-year use/occupancy rule.

If the home is sold for less than the taxpayer paid for it, the availability of the exclusion becomes irrelevant. (This can happen under certain circumstances--for example, when the home is located in an economically depressed area.) If the home is converted to a rental property before it is sold, however, the economic loss upon the sale could become deductible even though such a loss is not deductible for a personal residence. It is not totally clear under existing law, however, whether the loss upon the sale of a rental property is deductible as an ordinary loss or only as a capital loss subject to the annual \$3,000 capital loss limitation.

RECENT CASES AND RULINGS

HUSBAND AND WIFE'S LIFE INSURANCE TRUSTS HELD NOT INCLUDIBLE IN RESPECTIVE GROSS ESTATES

In a private ruling (Ltr. 200426008), the IRS held that separate life insurance trusts created by a husband and wife at the same point in time were not includible in the gross estate of either grantor-insured. Under the facts of the ruling, the husband (H) created a life insurance trust to benefit his wife (W) and son (S). The life insurance trust created by the wife (W) benefited H, S, and alternate beneficiaries. The issue in the ruling is whether the so-called reciprocal trust doctrine applies to each trust. Under the reciprocal trust doctrine, trusts created separately by two individuals benefiting each other will be treated as if the trust created by each grantor created a retained life interest for the grantor. A retained life interest renders the trust includible in the grantor's gross estate under IRC Sec. 2036(a). To reach this conclusion, (1) the trusts must be interrelated, and (2) the economic positions of the grantors must remain unaltered by the creation of the trusts. If the reciprocal trust doctrine applies to the facts in the ruling, the life insurance trust created by H will be included in his gross estate at the time of his death, and the trust created by W will be included in her gross estate at the time of her death. Of course, this is exactly what the grantors are trying to avoid in creating irrevocable life insurance trusts.

Each life insurance trust contains some identical language with respect to benefiting the spouse of the grantor and the son. In addition, the trusts contain a clause to eliminate the grantor's spouse as a beneficiary if a divorce or legal separation has occurred (or an action is pending to divorce or separate). However, the trusts differ in several respects. H's trust provides W with certain invasion rights and limited testamentary powers of appointment if W survives S. W's trust provides that H does not become a beneficiary until or if (1) his net worth is below a stated threshold, (2) his income from personal services is below a stated compensation threshold during a year, and (3) the date he receives a benefit is 3 years after W's death. The IRS concluded that the trusts are not reciprocal because they are sufficiently different substantively as to not be interrelated.

This letter prepared, with the help of a nationally recognized tax authority, intends to promote interest in more comprehensive tax and estate planning. References are intentionally brief. If a topic interests you, you should investigate it more thoroughly with your qualified tax advisor. Effective tax and estate planning should involve competent advisors in relevant law, accounting, trusts, life insurance and investments. The knowledge and experience of each in their specialties can make the difference between a wealth transfer that works as intended and one that does not. Please seek competent counsel to determine and satisfy your individual needs.

*Positioning our clients
for the future*



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