



# Advanced Planning Strategies

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Dear Reader,

There has been significant activity with respect to the federal wealth transfer tax system (i.e., the gift, estate, and generation-skipping taxes). The current rules permit each taxpayer to make total taxable gifts of \$1 million during his or her lifetime. This gift tax exemption is not scheduled to change. The estate and generation-skipping transfer taxes have an exemption of \$2 million at death. The exemption at death rises to \$3.5 million in 2009, followed by complete repeal in 2010. However, the estate and generation-skipping transfer taxes will be reinstated in 2011 with a \$1 million exemption unless there is further Congressional action. A measure to permanently repeal the estate and generation-skipping taxes passed the House last year but failed to garner enough votes in the Senate in June.

There have been several compromise proposals, with larger exemptions and lower maximum rates (now 46 percent), to reform the estate tax in lieu of repeal. Compromise attempts, which have failed to gain momentum in the past, will probably be necessary no later than 2008 with the law currently in place. The reason that necessitates the change is that the timing of death will result in extraordinary tax differences in 2008 to 2011. For example, a decedent with a \$3.5 million taxable estate would have \$675,000 in estate taxes if death occurs 2008, zero estate tax for death in 2009 and 2010 (all estates would not be taxed for deaths in 2010), and \$1,220,000 of federal and state estate taxes for death occurring in 2011 and beyond. It is highly unlikely that Congress will allow this level of motivation to an individual and his or her family to affect the timing of life and death decisions.

The House passed a reform proposal in June (The Permanent Estate Tax Relief Act) to increase the exemption to \$5 million per taxpayer with rates of 15 percent for estates up to \$25 million and 30 percent for the largest estates. These rates would increase to 20 and 40 percent, respectively, in 2011. Another somewhat obscure provision would permit any unused exemption at death to carry over to a decedent's surviving spouse, resulting in as much as a \$10 million exemption at the survivor's death. This carryover would change current document-drafting strategies and probably require changes to affected taxpayers' wills and living trusts. There will be much debate in the Senate due to the cost of the proposal, which is estimated at \$602 billion between 2012 and 2021.

We'll let you know how this turns out and how it affects your planning as soon as any developments occur.

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

## **PLANNING FOR THE SALE OF A PERSONAL RESIDENCE; SPECIAL CONSIDERATIONS FOR VACATION HOMES**

The tax laws applicable to home sales and vacation homes raise issues in tax planning when selling a principal residence or correctly characterizing a “vacation home.” In this letter we will cover several of these issues to help homeowners understand the proper strategies for avoiding tax and maximizing deductions 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. However, if 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 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 does not 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. This 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. If the home is currently being used as a home office at the time of sale, however, the exclusion will apply only to the personal portion of the home. In essence, two sales have occurred: a sale of a principal residence and a sale of commercial realty. 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 that was previously used as a home office. The entire home will qualify for the home sale exclusion, but any gain that is attributable to depreciation previously claimed for the business portion of the home will be taxed as described above.

### **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 personal residence for purposes of the 2-year use requirement, as 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 because of a change in employment or 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 requirement.

Special rules apply to ease the qualification for the exclusion for 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 when 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 ARE TAKING THE PLUNGE**

If a couple is planning to marry 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 will be available to each of them before their marriage for the sale of either home (or both homes). However, the maximum \$500,000 exclusion will be available only for a home that a married couple has occupied as a personal residence for 2 years out of the 5-year period. If one of the spouses sold a home just before the marriage and used the exclusion, then 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.

## **PLANNING WITH VACATION HOMES**

As the ownership of vacation homes increases, the importance of careful tax planning for ownership also increases. This letter reviews some tax considerations for the owner of a second home.

Under IRC Sec. 280A, a taxpayer's residence falls into one of three categories: a residence for personal use only, a rental property, or a residence that is also a rental property for part of the year. This characterization is determined annually by the number of days during the tax year that the taxpayer rents out the residence at a fair market rental and by the number of days that the residence is used for personal purposes.

**Personal Use Residence.** If the property is rented out for less than 15 days during the year, both the income and the expenses related to the rental are ignored. However, taxpayers are still permitted the itemized deductions for mortgage interest expense, real estate taxes, and casualty losses that are available to all homeowners.

**Rentals Not Qualifying as Residence.** If the property is personally used by the taxpayer for less than the greater of 15 days or 10 percent of the rental days, it is classified as a rental-only property. As a result, the itemized deductions for mortgage interest expense and real estate taxes will not be available. However, the taxpayer will be able to deduct all expenses related to the rental of the property, including interest and taxes, even if these expenses are in excess of the rental income from the property. Further, taxpayers should take note that any rental loss is subject to the passive activity rules

of IRC Sec. 469. Generally, if the taxpayer-owner actively participates in the rental of the property (e.g., approves tenants, schedules maintenance, etc.), rental losses of up to \$25,000 can be deducted against other income. The benefit of this exception to the passive loss rules is phased out at the rate of 50 percent for each dollar of adjusted gross income (AGI) over \$100,000. Therefore, taxpayers with AGIs in excess of \$150,000 are not entitled to a current rental loss deduction.

**Mixed Use Residence.** If the property is rented for more than 14 days *and* personally used by the taxpayer-owner for the greater of 14 days or 10 percent of the rental days, there must be an allocation of the expenses between the rental and personal-use days. The deduction is limited to the gross rental income so that no rental losses will be currently deductible.

In applying the gross rental income limitation, expenses are deducted in a specific order: first, those items that would be deductible without regard to the rental (e.g., mortgage interest and real estate taxes), followed by those items that do not result in basis adjustments (maintenance, repairs, insurance, etc.), and finally, those items such as depreciation that will adjust the property's basis. Any expense that is disallowed for the current year will be carried over to the succeeding taxable years.

## **SOME VACATION HOME TAX POINTERS**

Because the characterization of the residence is made annually, planning opportunities exist if the taxpayer is able to control the number of days of rental and personal use. For example, if a taxpayer has an AGI under \$100,000, the optimal tax treatment is to have the residence characterized as a rental-only property with up to \$25,000 of rental losses being deducted against other income. In such cases, personal use of the residence should be limited to 14 days or less during the year. As previously described, for taxpayers having AGIs over \$150,000, the \$25,000 exception to the passive loss limitation is completely phased out. As a result, with no rental loss currently deductible, the rental-only property characterization would prove undesirable unless the taxpayer had other rental income to offset this rental loss. These taxpayers would be wise to make sure they personally use the unit for at least the greater of 14 days or 10 percent of the rental days in order to preserve their itemized deductions for mortgage interest expense and real estate taxes.

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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