



Advanced Planning Strategies

Albert E. Gibbons, CLU, ChFC, AEP
President, AEG Financial Services

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The debate has begun in earnest over the health care reform. The obvious issues are how the health care options will be structured and how the package will be financed. The Senate has been through a couple of drafts of the “Affordable Health Choices Act” that provides a government-run health plan to compete with private insurers. The House of Representatives has a plan (HR 3200, a mere 1018 pages) that includes a surcharge on high-income taxpayers that would be imposed beginning with joint filers with adjusted gross income (AGI) over \$350,000 (\$280,000 for single filers). The surcharge begins at 1 percent and tops out at 5.4 percent for AGI above \$1 million. This proposal will certainly be a main focus of the debate. There are also penalties for employers that don’t provide coverage and individuals who don’t acquire coverage. Although President Obama wants a bill before the August recess, this legislation may take some time and its passage is not a sure thing. We’ll give you the full details as legislation develops.

The IRS released a publication that explains how a taxpayer should establish or adjust the amount withheld from a paycheck for 2009. Publication 919 “How Do I Adjust My Tax Withholding” brings this decision up-to-date for the many recent changes in the tax law. The publication describes how to check and make the appropriate adjustments to tax withholding. This decision along with determining the appropriate estimated payments, when applicable, could prevent inadvertent penalties next April.

The IRS publishes many interesting statistics with respect to taxes. The preliminary report for 2007 individual income tax returns presents virtually every item on the Form 1040 as reported on returns and breaks this down by income categories. Here’s some basic deduction data reported by income categories:

Adjusted Gross Income— 1000s	State and Local Taxes	Medical Expenses	Charitable Contributions	Interest Paid
50-100	3,053	6,690	2,612	10,558
100-200	6,015	9,922	3,790	13,766
200-250	10,868	22,810	5,733	18,030
250 & above	39,454	32,813	23,817	28,110

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

PLANNING FOR THE SALE OF A PERSONAL RESIDENCE UNDER THE NEW REQUIREMENTS

The tax laws applicable to home sales and vacation homes have always presented opportunities and pitfalls when selling a principal residence and correctly characterizing a "vacation home." In this letter we will discuss several of these issues to help homeowners understand the proper strategies for avoiding tax on these transactions. Recent changes under the Housing and Economic Recovery Act of 2008 became effective January 1 and may have a significant impact on traditional planning in this area.

BASIC RULES FOR THE HOME SALE EXCLUSION

The gain realized upon the sale of a principal residence will not be taxed except to the extent that the gain exceeds \$500,000 of gain for married taxpayers filing jointly and \$250,000 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. Temporary absences, such as vacations are considered use by the taxpayer. 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. That is, 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. Under current law, the exclusion applies to only one sale or exchange every 2 years.

Any depreciation allowed or allowable 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 for your home-based office at the time of sale, you do not have to allocate the home's capital gain between the home and the business office. However, if the home office is detached (i.e., an unattached structure) from your primary residence, 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. Again, any gain attributable to depreciation previously allowed or allowable 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, health, or unforeseen circumstances and the ownership and use requirements are not fully met. The change in employment test must satisfy the requirements for a moving expense deduction (a 50-mile distance test). 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.

Example: Johnny, a single taxpayer, purchased his home on February 1, 2009 for \$350,000. His employer has reassigned him to a new location and he sells his home for \$425,000 on November 1, 2009. Although Johnny has realized a gain of \$75,000, he may exclude the entire gain (\$250,000 times 9/24 equals \$93,750) since the sale was due to a change in employment and the amount of his gain is below the pro-rated exclusion amount.

The “unforeseen circumstances” requirement is quite broad, and extends beyond a change in employment or health. Unforeseen circumstances allowing for a reduced exclusion may include: death of a qualified taxpayer, multiple births resulting from the same pregnancy, divorce or legal separation, loss of employment triggering eligibility for unemployment compensation, a change in employment status resulting in the owner's inability to pay the mortgage and reasonable basic living expenses, and bullying. In a 2008 private ruling (Ltr. 200820016), a reduced exclusion was permitted where a taxpayer sold her home within two years due to the taxpayer's daughter being subjected to unruly behavior, verbal abuse, and sexual assault while riding the bus to school. However, it should be noted that marriage and adoption are absent in the above safe harbor definition for unforeseen circumstances...

For sales occurring after 2007, the time period during which a surviving spouse may sell a principal residence and use the joint filers' \$500,000 exclusion has been extended to no later than 2 years after the death of the spouse. Prior to 2007's Mortgage Forgiveness Debt Relief Act, a surviving spouse was only entitled to an individual exclusion of \$250,000 for sales subsequent to the death of a spouse. Under either scenario, the surviving spouse who jointly owned the home receives a basis adjustment for the date-of-death fair market value of the home for one-half of the principal residence inherited.

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 FOR THOSE CONTEMPLATING MARRIAGE

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 principal 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, a taxpayer (whether an unmarried person or a married couple filing jointly) can have only one principal residence at any given time for exclusion purposes.

NONQUALIFIED USE RULES FOR SALES OCCURRING IN 2009: SECOND HOMES CONVERTED TO PRINCIPAL RESIDENCE

Taxpayers owning a principal residence and a second home that has appreciated in value may have a new set of hurdles to overcome in optimizing the home sale exclusion. Last year's Housing and Economic Recovery Act modified the application of the \$250,000/ \$500,000 exclusion, but ONLY in situations where the taxpayer is converting their second home to their principal residence. Under the new law, when the converted second home is sold, some portion of the gain may be taxable, even though the taxpayer has lived in the home for the required 2 years or more out of 5-year period ending on the sale date. Second homes affected by the change are any residences owned by a taxpayer that are not used as a principal residence. Thus, both vacation and rental properties could be affected.

Effective for sales or exchanges as of January 1, 2009, taxpayers that convert a second home to a principal residence may have a taxable event on non-qualified use occurring after 2008. The gain on sale allocated to periods of nonqualified use is based on a ratio which compares the nonqualified use (i.e., rental, investment, or second/vacation property) to the total time that the property was owned by the taxpayer. Nonqualified use does not include periods when the homeowner vacated the property for military or other official service, a change of employment, health, or other unforeseen circumstances. Appraisals are not required and taxpayers who have held properties for a long period of time will not be disadvantaged. Similar to prior law, depreciation attributable to business use is subject to taxation. The portion of the gain from the investment/rental use is a taxable investment gain taxed at capital gain tax rates. The gain derived from the period of the principal residence use will be taxed under the home sale exclusion rules and may be eligible for part or all of the \$250,000/\$500,000 exclusion.

The new law's formula for nonqualified use does not penalize taxpayers owning non-principal residence property before 2009. However, after 2008, when a second home is converted to a principal residence, the rule of thumb will be that the longer the period of use as a principal residence, the greater the amount of the excludable gain.

Example: Charlene, a single taxpayer, bought a vacation property for \$250,000 on June 1, 2009. On June 1, 2012, she converts the property to her principal residence. On June 1, 2014, she sells the property for \$500,000, realizing a gain of \$250,000. Charlene has owned the property for 5 years and has used it as a principal residence for 2 years. Based on her period of use and ownership, 40 percent of the gain ($2 / 5$) is eligible for the \$250,000 exclusion (2 years use as a principal residence divided by 5 years of ownership). The remainder of the gain (60 percent, i.e., 3 years as non-principal residence divided by 5 years of ownership) will be taxed at the applicable capital gains tax rate in the year of sale. Although the total gain is \$250,000, \$150,000 ($\$250,000 \times .60$) will be treated as a capital gain. If the capital gain tax rate in 2014 is still 15 percent, the total tax would be \$22,500 ($\$150,000 \times .15$).

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. Securities and Investment Advisory Services offered through Capital Analysts Incorporated, Member FINRA/SIPC. AEG and CAI are independent non-affiliated entities.

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for the future***



**Albert E. Gibbons, CLU, ChFC, AEP
AEG FINANCIAL SERVICES**

1288 Valley Forge Road, #53
Phoenixville, PA 19460

Tel. (610) 917-8940

Fax. (610) 917-8962

Email. algibbons@algibbons.com

Web. www.algibbons.com