SPECIAL REPORT

Gimme Shelter: Hidden Real Estate Tax Bombs to Avoid

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Published by:
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Washington, DC 20001
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Gimme Shelter: Hidden Real Estate Tax Bombs to Avoid *Bob Carlson, Editor – Retirement Watch*

Many older homeowners are facing a problem that not long ago was considered unthinkable. These homeowners face taxable capital gains on the sale of their homes, despite the generous $500,000 exemption for married couples and $250,000 for unmarried. The real estate market cooled after 2005 and declined in 2007 and a few years after. But prices have recovered in many areas, and in many areas home prices were red hot for years. The bottom line is that today the gains of many longtime homeowners are above the exempt amount. Even after the declines of the mid-2000s, many longtime homeowners have substantial gains.

Appreciation was so strong before 2005 and after 2010 that even homeowners with fairly modest incomes and average homes for their areas could reap gains of more than $500,000 on their principal residences.

Before 1997, a homeowner avoided taxes on gains from a residence by rolling over the gain into a new residence. The tax basis of the old residence was carried forward, so that the gain eventually could be taxed if a new home of equal or greater value were not purchased. That rule was changed in 1997, though anyone who rolled over gains before then retains the low basis of the original home.

Because of the carried forward tax basis and the unrelenting real estate appreciation in many areas (especially on the coasts), many people, especially those who bought their first homes before the 1990s, now have gains over the years that total more than $500,000. It is not uncommon for a longtime homeowner to have a market value that exceeds the basis by more than $500,000.

Current law allows an individual to exclude from income up to $250,000 of gains from the sale of a principal residence. This exemption can be used no more than once every two years. Married couples can exclude up to $500,000 of gains from a principal residence every two years. Purchasing another home of equal or greater value no longer is required to defer gain. Taxpayers with large gains who don't want to pay part of their home equity in capital gains taxes have a few options.

Option #1 is to take any capital losses you have in other assets and use those to offset the gain. You might have some longtime investment dogs with sizeable losses to which you've been hanging on. This would be a good time to cut them loose. Let the losses offset the taxable gain from selling your home.

Option #2 is to be sure you have detailed records of the cost of the home plus any capital improvements. A capital improvement is added to the cost of a property to get the tax basis. Many homeowners overlooked this in the past because it didn’t seem important to compute the basis accurately.

Homeowners assumed they would be able to defer gains indefinitely or be comfortably under the exclusion limit. Now, computing the basis accurately is important to homeowners who are pushing the tax-free limit.

Regular repairs are not improvements. An improvement is an expenditure that adds value to the home, prolongs its useful life, or adapts it to new uses. A repair maintains the home in good condition but does not add value or prolong its useful life.

Examples of repairs are repainting the house, fixing gutters or floors, and repairing leaks or plastering.

Examples of improvements are adding a recreation room or bathroom to an unfinished basement, putting up a new fence, putting in new wiring or plumbing, and paving an unpaved driveway. An addition to the house also is an improvement.

IRS Publication 523, Selling Your Home, details the difference between repairs and improvements. It is available free on the IRS website at **www.irs.gov.** Also be sure that your cost basis includes all the allowable costs. Settlement fees and other closing costs that are not related to a mortgage usually are added to the basis. These can include abstract fees, survey fees, legal fees, and transfer taxes. A full discussion of all the items included in the tax basis is in IRS Publication 523. It can be ordered free at **www.irs.gov**.

Option #3 is to hold the property. If the home is not sold, it will be included in the owner's estate. The heirs who inherit the house get to increase the tax basis to the current fair market value. The capital gains realized during the prior owners' lifetimes will escape all capital gains taxes. There might be estate taxes due on the property (though for only a few people after the 2017 tax law), but those can be easier to plan for and reduce then the capital gains taxes. If the owners already have decided to move, the house can be turned into a rental property. They could hold it and rent it for the rest of their lives.

Option #4 is to sell in an installment sale. This will not reduce the amount of taxable gain. But the installment sale will spread the gain over the years the payments are made instead of lumping it into one year. This might make the tax easier to pay. Spreading out the gain also might make it possible to plan ways to reduce the taxes, such as by taking capital losses or increasing deductions each year to offset the gains.

An installment sale means the sellers take a note from the buyers. Some sellers might like the steady stream of income, and the interest might exceed what can be earned on safe investments today. A disadvantage is that the sellers depend on the buyers' making the regular payments for years. If payments are missed, the sellers have to initiate a foreclosure procedure to get the home back so it can be re-sold. The sellers also are taking the risk that in the meantime the buyers have not maintained the house and have diminished its value.

Some people sell the home on an installment basis to their children as part of an estate plan. That removes the house from the parents' estates, gives the parents cash flow from the equity, and transfers the home and its future appreciation to the children. The children must have the cash flow to pay the loan through their own income, gifts from the parents, or from renting the property.

Option #5 is to rent the home for at least a year, turning it from a principal residence into an investment property. Then, the house can be exchanged tax-free for another investment property. This defers the capital gains taxes again. The basis of the old home is transferred to the new investment property.

If the new property is the home in which you eventually want to live, rent it to someone else for at least a year. That ensures the property qualifies as an investment property and that the gain is deferred. After that you can move into the property and establish it as your residence.

This strategy is fairly tricky. The values of the two properties have to be equal. If the property you sell is worth more than the one you buy, and you receive additional cash or other property as part of the deal to make things equal, then the gain will be taxable to the extent of that money or property received. It also gets tricky when there is a mortgage on either property.

All the rules for a tax-free exchange of investment properties must be met for this strategy to be effective. I recommend working with an attorney who has experience in like-kind exchanges, as well as a real estate broker who knows the ropes. There are many details that must be followed.

Beat Those Higher Property Taxes

Real estate taxes are more and more of a burden on homeowners, especially older owners. Even when residential real estate values aren't rising, tax rates can rise. Local governments need revenue, and residential real estate taxes are a key source of revenue for many of them.

It might be possible to cut your property taxes. Real estate taxes can be reduced by appealing your property tax assessment. To do that, you have to act quickly. Most localities require you to object to an assessment within either 30 days or 60 days after it is received. Miss the deadline, and you can't challenge your tax bill for another year. Early spring is the time of year in most of the country when action is required, but check your locality to determine its timeline.

Some surveys indicate that 50% or more of properties are over-assessed. I think that's an exaggerated number. It is based on the fact that in most jurisdictions, about 50% to 60% of homeowners who appeal their assessments to the final administrative level get some kind of reduction. But very few people file appeals, and many of them settle before the final step.

The exact appeal process differs around the country, but the basics tend to be similar. The first step is to get your notice of appeal in by the deadline. Most areas discourage appeals by mailing new assessments at a busy holiday time and requiring notices of appeal to be filed within 30 or 60 days. Fortunately, your full case for a lower assessment doesn't have to be prepared in that time. You only need to notify the government of your intent to appeal. Many areas now allow an appeal notice to be filed online and will confirm receipt by e-mail. After filing the notice, gather your facts.

Determine the relationship between the assessed value and market value. Some areas use full market value as the assessment. Others cap the assessment at a percentage of market value or a percentage increase over the prior year's value, regardless of market value. You need to determine the formula your jurisdiction uses and work backwards to determine the estimated market value the government used.

If you believe the home could be sold near that estimated market value, your appeal is unlikely to be successful. You should withdraw it. Otherwise, consider developing evidence to support the most common grounds that win appeals. The easiest and most important ground for winning an appeal is that there was a mistake. First check the calculations to make sure there was not a data input or arithmetic mistake.

The assessor does not visually inspect each house. The government's records (such as building permits) are examined to determine the features of each house. Then, the market values of homes that are believed to be similar in features and location are estimated. Check the government's worksheet on your home. Many governments now have the worksheet data available online; others require that the information be requested. Some governments also provide a list of recent sales of what are considered to be comparable properties.

The worksheet might say that your basement is finished when it is not. There could be other errors such as square footage, number of bathrooms, size of the deck, etc.

Also, survey your property for negative features that are not on the worksheet. Perhaps you have a bad foundation or some kind of damage that permanently reduces its value. Some areas will reduce your assessment if you can point out that the comparable sale properties had updated kitchens or other features that yours lacks. Any physical evidence you can present with the appeal would be helpful. Evidence could include photographs and descriptions of your property and the comparable properties.

Those are your three main grounds for winning a real estate appeal: calculation errors; mistakes about the house; and factors about your house that make it not comparable to and less valuable than recent sales. In most areas there are several steps to the appeal process. The initial step often is to send some kind of writing to the assessor’s staff. This can be followed by an informal meeting or telephone call with the staff. If there is an obvious mistake about your property, you might be successful here.

The next step would be a more formal appeal to a Board of Assessment or similar body. If that fails, the final appeal usually is to the courts. Few taxpayers appeal to the courts because the potential costs outweigh the savings from winning the case.

Most jurisdictions make available statistics about real estate appeals. For example, in Arlington County, Va., in a recent year, of 59,000 homes assessed, only 648 filed for a review from the assessor's office. In 28% of those cases, the office reduced the assessment. Another 266 appealed to the Board of Equalization, and 55 of them had their taxes reduced.

Don't pay for expensive seminars or publications. The assessor's office usually is helpful and will provide all the information you need. Many localities have one or more taxpayer advocacy groups that provide tax appeal information. You also might want to check the library for books on reducing property taxes.

Make Sure Home Sale Gains Are Tax Free

Those of you with two or more homes might owe more taxes on the sale of a home than you thought. The rules on taxing home sales also might be an issue for anyone owning an RV, camper, or boat.

Those are the consequences of a federal court case. Under the ruling, the IRS and the courts can decide that you have no principal residence and therefore don’t qualify to exclude the gain from gross income.

Most people who own two or more homes assume that they will be able to sell each home in turn and owe no taxes on the gains. Those who own an RV or boat often assume that they can sell those homes tax-free at any time.

A federal court ruled otherwise. In fact, it indicated that owners of multiple homes might not be eligible to exclude the gains from the sales of any of their homes. (*Guinan vs. United States*, D.C. Ariz. 2003) Homeowners could pay tens of thousands of dollars in capital gains taxes they did not anticipate.

As discussed earlier, the 1997 tax law created a generous exclusion, in section 121 of the tax code, for capital gains realized from the sale of a principal residence. The rule allows a single taxpayer to exclude up to $250,000 of gains, and married taxpayers filing jointly to exclude up to $500,000 of gains. To qualify for the exclusion, the seller must have owned the home and used it as a principal residence for any two of the five consecutive years before the sale. The years of ownership and use as a principal residence need not be the same years. The rule provides some tax planning opportunities (but see the next section on 2008 tax law changes before implementing these strategies).

One opportunity used to be serial homeownership. Buy a home. Fix it up or let it appreciate for two or more years while you live in it. Sell it at a tax-free gain, then buy another home and start the process again. But Congress tightened the law so the gain exclusion doesn’t apply to serial homeownership. You can't use the exclusion if you used it to exclude the gain on another home within two years prior to the current sale. Also, only part of the exclusion can be used if the home had a nonqualifying use during the five-year qualifying period. For details, see the section below on the 2008 changes.

Another opportunity is for owners of several homes. Establish one home as a principal residence for two years. Then sell it, pocket the appreciation tax free, and establish the second home as the principal residence. After more than two years, the second home can be sold, and the gains will be tax free. You can cash out of both homes without owing taxes on any of the gains.

The court case, however, focuses on a result many did not anticipate. Owners of more than one home might not be able to establish any home as a principal residence. If that is so, none of the homes could be sold tax free.

A taxpayer can have only one principal residence at a time. That is why it is called the principal residence. The tax code and regulations say that the principal residence is determined by a "facts and circumstances" test. The most important factor is the amount of time spent in each location. The location at which the taxpayer spends a majority of the time normally is considered the principal residence.

Yet, other factors can be considered when the IRS or the courts believe they are appropriate. Some factors listed in the regulations are: the address on documents such as income tax returns, driver's license, automobile registrations, voter registration, bills, and correspondence; where bank accounts are located; memberships in a church, club, or other organization; and where most of the taxpayer's personal possessions are kept. Another factor is the state or locality with which local income tax returns are filed.

In the case, the taxpayers purchased a Wisconsin residence in March 1993 and sold it in September 1998. They already owned a Georgia home when they purchased the Wisconsin home. The Georgia home was sold in 1996, and an Arizona home was purchased. The issue was whether the sale of the Wisconsin home in 1998 qualified for the exclusion of gains.

The couple aggregated the five years before the sale and said they spent 847 days at the Wisconsin house, primarily from May to September but they also returned to Wisconsin for Green Bay Packers home games. They were in the Georgia home 563 days, and the Arizona house 375 days. That means they spent over half the days during the five-year period at the Wisconsin house.

The court, however, concluded that the five-year period in aggregate is not considered to determine the principal residence. Any two-year period also is not considered. Instead, each calendar year is considered separately. The taxpayer has to show where he spent the majority of his time each year. To establish a home as the principal residence, he must spend the majority of his time there in each of two separate years.

The court concluded that in this case the taxpayers did not have any principal residence. They did not spend a majority (meaning more than half) of their time in any of the homes during at least two years of the five-year period.

Looking at other factors also did not help the taxpayers. They had cars registered in each location, bank accounts in each location, and received mail at each location. The court also was persuaded by the fact that no income tax returns were filed in Wisconsin, and the taxpayers never had Wisconsin driver's licenses.

The case was decided by a federal district court in Arizona, so its reasoning applies only to residents of that district. A number of tax practitioners disagree with the court's ruling that the use is looked at separately each year instead of over the five years. Other courts eventually might disagree with this court's interpretation.

What is clear is that it is possible for a taxpayer who owns multiple homes to have no principal residence under the tax law. Keep in mind that under the tax law, a residence can be a recreational vehicle or a boat. Any facility with sleeping, cooking, and toilet facilities can qualify as a residence. Time spent in those locations takes away from time spent in the home. The situation can be especially precarious for a taxpayer who owns more than one home, an RV, and perhaps a boat with the appropriate facilities. Each night in the second home, RV, or boat takes away from the primary house’s total days used.

Taxpayers who own a business often have much of their mail, especially mail related to their financial accounts, sent to their offices. To the IRS, that is another factor indicating the taxpayer has no principal residence and cannot exclude the gain from the sale of any house. The key for taxpayers with more than one home is to begin planning at least two years before they anticipate selling a home. Work with a tax professional to document a pattern of behavior that establishes the desired house as the principal residence.

The days spent in the house to be sold are the primary factor, but they are not the only factor. Attention must be paid to tax filings, voter registration, driver's licenses, church membership, club memberships, volunteer activities, and other actions. The address listed on mail, especially mail for financial accounts, can be a key factor.

Don’t Overlook 2008 Changes

Under the rule enacted in a 2008 law, gain cannot be excluded to the extent it is allocated to years when the home had a nonqualified use, meaning it was not used as a principal residence by the owner or a spouse or former spouse. Example: A married couple bought a beach house on Jan. 1, 2014, for $500,000. They rent the home for three years until Jan. 1, 2017, and then they move in and establish it as their principal residence. They plan to sell on or after Jan. 1, 2020. Let's say the sale price is $1 million.

Under the 2008 rules, they cannot exclude the entire $500,000 of gain. Three of the five years they owned the property it was a rental, which is a nonqualifying use. The home had a qualifying use for only two of the five years, so only two- fifths of the gain, or $200,000, can be excluded from gross income. The rest is taxable as long-term capital gains.

The law is aimed at people called serial home sellers. These individuals exploited the 1997 law by buying and selling homes every few years. Some would buy homes that needed work, fix them up, and sell them for nice profits. Others simply relied on appreciation to generate gains when they sold.

The law also is aimed at owners of multiple homes. Some of these owners plan to liquidate these homes by establishing one as a principal residence for two years, selling, and establishing another of their homes as a principal residence for two years. They plan to use the maximum exclusion for each of the homes over time. The law does provide exceptions if the owner is temporarily absent from the home for a period not to exceed two years due to a change in employment or health or unforeseen circumstances. The restrictions are effective for sales after 2008 and only for periods of nonqualified use after 2008.

Tapping Real Estate Wealth

Managing the equity in appreciated homes and second homes is an unexpected challenge for many, especially those living on the coasts

One problem is that the residential real estate wealth is not cash. A family can be wealthy on paper but struggle to meet expenses. Or the family might have enough income to meet regular expenses but be concerned about the future, especially medical and long- term care expenses. In addition, valuable real estate uses cash. There are real estate taxes plus maintenance and repairs. Longtime owners can spend more on real estate taxes today than they used to spend on all the property's expenses. If they continue to own the property, significant estate taxes could be incurred.

Too often, the owners believe the only solution is simply to sell the home. A sale frees up the wealth, but it also could incur capital gains taxes that reduce the wealth. Many homeowners have gains that exceed the $500,000 tax-free amount for married couples or $250,000 amount for singles. Second homes do not qualify for the exemption on gains. A sale also takes the enjoyment and use of the home out of the family.

Perhaps most importantly, a sale means the family foregoes future appreciation in the property. Most areas should see steady appreciation over the long term of a decade or more. Fortunately, a straight sale of the real estate is not the only option. Here is a review of some strategies homeowners can use to continue enjoying valuable real estate while making use of at least some of the home equity.

Loans are one option. Retired people generally avoid debt, though recent trends indicate more retirees than in the past carry debt. There are a couple of ways debt can be useful. One reason to consider a loan is that the appreciation rate on the home might exceed the interest paid on a loan, especially at today's interest rates and when the loan balance is of only a portion of the home's value. If you borrow 50% of the home's value at 6% interest, the home has to appreciate 3% annually for you to break even.

A homeowner can set up a line of credit. There are several advantages to the line of credit. Only the amount actually needed is borrowed and only when the need arises. That means no interest is charged until the line of credit actually is tapped. When money is borrowed, generally only interest payments are required. Paying the principal can be deferred. The length of the deferral varies from lender to lender.

A reverse mortgage is another type of loan we discuss regularly in *Retirement Watch*. The articles are available in the members' section of the web site at **www.RetirementWatch.com** in the Cash Watch section of the Archive.

Reverse mortgages have some flexibility. You can receive a lump sum, line of credit, monthly annuity, or other stream of payments. You can borrow the amount you anticipate needing during retirement to supplement other sources of income. No payments are due until the borrowers pass away or the home is sold. The downside of reverse mortgages is that they are expensive. Interest and other fees can be quite high.

A private annuity is another option. In a private annuity, the parents sell the property to their children. The children promise to make a series of payments to the parents for life. The amount of the payments is determined by IRS tables based on the property's current value, current interest rates, and the parents' ages. The obligation to make payments ends when the parents pass away. The private annuity gives the parents cash flow and transfers the property to the children. In addition, the parents recognize capital gains on the sale only as the payments are received.

The children have several options. Perhaps collectively they can afford to make the payments. Or, if it is a second home or the parents move, perhaps renting the home can help make the payments.

Another option is for the children to sell the home. Because the children just purchased the house, they won't owe capital gains taxes. The entire sale proceeds can be invested, perhaps in a trust, and used to make payments to the parents for their lives. This does not keep the home in the family. But it does get cash to the parents and keeps all or most of the value of the property in the family instead of only the after-tax value. Charitable gifts can generate more after-tax wealth for the family, though they eventually will deprive the family of the home and its future appreciation.

The parents can remain in the home by giving a remainder interest to a charity. The parents retain the right to live in the home for life. The charity receives title to the property after the parents pass away. The benefit to the parents is that they get a charitable contribution deduction for the value of the charitable remainder interest. The deduction is determined using tables in IRS regulations and is based on the value of the property, the parents' ages, and current interest rates. The older the parents are, the greater the percentage of the home's value that is deductible. The deduction reduces the parents' income taxes until it is exhausted, and that generates extra cash for the parents.

A charitable remainder trust also is worth considering. The parents create the trust and give the property to it. The trust sells the property, and no capital gains taxes are due because it is a charitable trust. The full sale proceeds are invested. The parents receive income for life, and they have some flexibility in setting the formula for the income payments and whether they are fixed or will increase with the value of the trust's portfolio. The parents also get a tax deduction for the value of the charity's remainder interest when the trust is created. After the parents pass away, the charity gets the value of the trust.

So, there are three tax benefits: there are no capital gains taxes on the appreciation in the property; the parents get a tax deduction for making the gift; and there are no estate taxes on the property. In addition, the parents get income from the trust.

Biography

Bob Carlson is editor of the monthly newsletter and website, *Retirement Watch.* He has served on the Board of Trustees of the Fairfax County Employees' Retirement System since 1992 and been chairman since 1995. The system has more than $4 billion in assets. Carlson was a member of the Board of Trustees of the Virginia Retirement System, which oversaw $42 billion in assets, from 2001-2005. He was appointed to the Virginia Retirement System Deferred Compensation Plans Advisory Committee in 2011.

His latest book is the revised edition of "The New Rules of Retirement" (Wiley, 2016; first edition 2004). He also co-authored "Personal Finance after 50 for Dummies" (with Eric Tyson; Wiley, 2015) and wrote "Invest Like a Fox…Not Like a Hedgehog" (Wiley, 2007).

He has written numerous other books and reports, including "The New Rules of Estate Planning," "Securing Your Lifetime Stream of Income," "Tax Wise Money Strategies, Retirement Tax Guide," "How to Slash Your Mutual Fund Taxes," "Bob Carlson's Estate Planning Files" and "199 Loopholes That Survived Tax Reform." He also has been interviewed by or quoted in numerous publications, including *The Wall Street Journal*, *Reader's Digest*, *Barron's*, *AARP Bulletin*, *Money*, *Worth*, *Kiplinger's Personal Finance*, the *Washington Post* and many others. He has appeared on national television and on a number of radio programs. He is past editor of *Tax Wise Money*.

Carlson also was a Commissioner on the Fairfax County Redevelopment and Housing Authority. Carlson is an attorney and passed the CPA Exam. He received his J.D. and an M.S. (Accounting) from the University of Virginia and received his B.S. (Financial Management) from Clemson University. He also is an instrument rated private pilot. He is listed in many editions of *Who's Who in America* and *Who's Who in the World*.

RWGM0224