Price & Farrington's Estate and Tax Planning *Fast*Facts

Oct./Nov., 2007

Estate, Tax, Retirement and Family Wealth Planning for Advisors+ Clients

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Estate and Tax Planning for Your House:
Being Smart About One of Your Biggest Assets

If your home is your family's most valuable asset — or certainly one of them — your goal should be to try to cut taxes on it in the same way you try to cut taxes on less valuable investments. Here are some ideas.

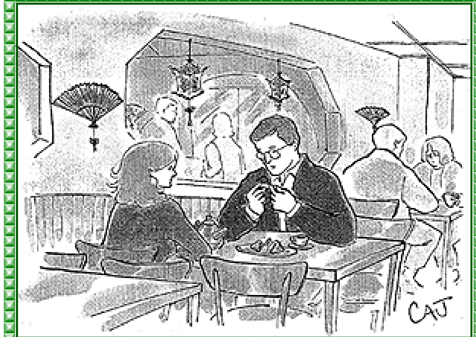
Tax basis. Because of the generous amount allowed for tax-free gain on home sales, many of our clients haven't done any tax planning for their homes. Most folks know that on the sale of a home up to $500,000 in gain can be taken tax-free by joint return filers, or $250,000 by single filers, when the home was owned and used as a primary residence for two of the prior five years. The reality is that these dollar numbers lose value to inflation every year, while most homes appreciate in real value. The compound effect may drive gain over the tax-free limit surprisingly quickly.

Example. Hank and Henrietta Homeowner bought a home for $300,000 that's now north $575,000. It will have to increase in value by another $225,000 to trigger a taxable gain, so they don't worry about it. But if the home goes up in real value 3% a year, gain will reach the taxable threshold in just six years, and taxable gain will increase every year thereafter.

It's important to remember to record the cost of all improvements you make to your home because they can be added to its purchase price to increase your tax basis in it. (Your basis will be subtracted from the sales price to determine the gain on a sale.) This applies to big-ticket such as room additions, landscaping and kitchen remodeling as well as to much smaller upgrades or improvements. Every dollar of improvement cost you record can avert tax on a future dollar of gain.

Joint Ownership. Many married couples own their homes jointly without thinking about it. If the titling is "***joint tenancy with right of survivorship***" (JTWROS), on the first death the property automatically passes to the surviving joint owner *outside* the will. This form of ownership not only creates potential ***creditor protection*** problems for the joint tenants during their lives (see *January, 2002 Fast*Facts and other *Fast*Facts on our website at www.pricefarrington.com), it can also create serious ***estate tax*** issues. Since the surviving spouse takes title to the entire asset outright, there is no way to fund a credit-shelter trust. There are also ***income tax*** issues that arise, i.e., does the house receive a 100% step-up in cost basis on the first death?

In contrast, owning a home in Washington as ***community property*** or as ***tenants in common*** lets each spouse make separate provisions for his/her interest in the home. In addition to ***tax*** consequences, we always have to examine the ***asset protection*** ramifications of different kinds of titling.



"It says, 'Someday you will die.'"

Avoid tax on gain. If you are ready to sell and your home has appreciated in value beyond the taxable threshold (a gain of more than $500,000 for married couples and $250,000 for singles), you can effectively sell it tax-free by donating it to a ***charitable remainder trust*** (CRT). The trustee then sells it tax-free and invests the proceeds to pay income to you for life. When you die, the remaining funds from the sale held in the CRT will pass to charity. You receive a ***charitable contribution deduction*** *today* for the present value of that *future* gift to charity. Several calculators that show the income stream and tax results of CRT donations are available on the internet. Enter "charitable remainder trust" and "calculator" in an Internet search engine. Or we can crunch the numbers for you. *Downside:* If you donate your entire house to a CRT, you lose control of the principal. You can only get the periodic payments (i.e., the income stream) from a CRT and nothing more, even in an emergency.

Ponder this.

From "The 100 Greatest Leadership Principles of All Time" (2007)…..

Intelligence:

► ***Many people have ideas on how others should change; few people have ideas on how they should change.***
Leo Tolstoy

► ***Those who know how to win are more numerous than those who know how to make proper use of their victories.***
Polybius

► ***If a man does not know to what port he is steering, no wind is favorable to him.***
Seneca

► ***There is no mistake so great as that of being always right.***
Samuel Butler

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Keep your home for life and get a deduction now. If you don't intend to leave your home to a family member, you can leave it outright to a charity instead—without setting up a trust—and continue to live in it for the rest of your life or a period of years you specify. You can take a ***charitable deduction*** *today* against income tax for the present value of your *future* gift to the charity. This is a special rule available only for homes. Your gift must be irrevocable, deeding the remainder interest in your home to a charity. *See* Internal Revenue Code Section 170(f)(3)(b).

Keep your home out of probate. The costs and delays involved in probating a home vary from state to state. Probate avoidance can be a cheaper, faster and certainly more private way to transfer assets. Holding title to your home and other assets inside of a ***revocable living trust*** allows you to transfer title to your assets efficiently, outside of a public, court-supervised probate. If you own homes or real property in more than one state, the property will trigger a probate in each state, compounding costs, delays and public filings. A living trust which holds title to all such property will avoid multiple probate proceedings.

Home Sweet Home

I'm moving out, but first I'm getting a thousand roaches. It said in the rental agreement, "Leave the place the way you found it."
Dolly Allen

We are in the process of buying a home. When you buy a home, you deal with realtors. Realtors are people who didn't make it as used - car salesmen.
Bob Newhart

We have one of those floor lamps with three degrees of brightness: dim, flicker and out.
Herb Shriner

Home is where the college student home for the holidays isn't.
Laurence J. Peter

Execute a "transfer and leaseback". If you want to create deductions for previously nondeductible home-ownership costs and also cut estate taxes, here's how: Give your house to an adult child (or other family member), then lease it back to continue living in it. Avoid ***gift tax*** by making annual gifts of partial interests in the home using the $12,000 per recipient ***annual gift tax exclusion*** ($24,000 when gifts are made jointly by a married couple) or using the $1 million ***lifetime gift tax exclusion*** ($2 million for a married couple).

Transferring the home, and the future appreciation in its value, reduces your taxable estate. The new owner can deduct home-ownership costs, such as utilities, maintenance, insurance and depreciation, as rental expenses — deductions not available to the family before. This will offset the rental income you must pay for continued occupancy and may even produce a deductible tax loss.

Sale and Leaseback. A sale and leaseback works similarly, except you *sell* your home to a family member and can take your gain tax-free, which can provide you with cash if you are house rich but cash poor. It is important that the lease rental rate be set at an arms-length fair market level. The downside to this strategy is that the family loses the ***stepped-up basis*** that applies to inherited property to eliminate capital gains on it. This cost, however, may be more than offset by saving 45% in estate tax on the transferred home.

Rent out before selling. If when you wish to sell your home the market is weak, you can lease it out for income until the market improves and sales prices rise. The home will still qualify for tax-free gain if it meets the two-of-five-prior-years test for ownership and residence, so you can rent it out for profit for up to three years while still taking tax-free gain on it.

QPRTs. Another effective transfer strategy for your home is a ***qualified personal residence trust*** *(QPRT).* The QPRT is set up to last for a term of years during which you

"It starts earlier every year."

can continue to live in the home before title transfers to, for example, the children. Following the term of years, the home—and any appreciation—has been transferred out of the grantor's estate at a discounted gift tax value.

Example. Quentin Q. Quigley is 55 and establishes a QPRT for his $500,000 home for a term of 15 years, with his child as the remainder beneficiary. If a 6.2% interest rate is used, the value of the gift is only $156,675. Considering the probable dramatic increase in the home by the end of the trust term, Mr. Quigley will have gifted away an asset worth (at 5% annual appreciation) $1,039,464 at an incredibly discounted gift tax cost. The gift tax can be offset by his lifetime $1 million gift tax exclusion amount, so there is likely to be no out-of-pocket gift tax cost to him. *For more on how QPRTs work, see our February, 2000 Fast-Facts and an article on QPRTs at our website, www.pricefarrington.com.*■

As year-end approaches, tax— and other sensitive—estate planning issues might need to be addressed. Please don't hesitate to contact us about your or your clients' planning concerns. ***G D P***