The Widow Trap – Part II

This is a follow up to my earlier article about taxation on personal residences after the passing of a spouse. The prior article gave an example of a person passing away in a non-community state. I thought it would be helpful to discuss the situation for community property states. As of the time of this article, there are nine community property states: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington and Wisconsin. Alaska has an "opt-in" that gives couples the option to make property their community property.

Most married couples hold title to their home as "Joint Tenants." This has a good aspect because it automatically passes full ownership to the surviving spouse when a spouse passes away. And it avoids probate. However, there is a hidden feature that can result in unnecessary income taxes for the surviving spouse. And that's the main issue I want to highlight in this article.

You may know that there is a Federal income tax exemption on gain from sale of a principal residence. If you are married, the tax-free portion of your gain is $500,000. If you are single, the amount is $250,000. In the case of a recently deceased spouse, the surviving spouse can use the $500,000 exclusion if the home is sold within 2 years of the death of their spouse. If the home is sold thereafter, the exclusion amount drops to $250,000. Many married couples have lived in their homes for many years and may have large "paper gains" in the value of their home. It is not unusual for those gains to exceed $250,000.

When a home is owned by a married couple and one spouse passes away, there is usually an adjustment to the basis of the home. This is very important because it can result in significant income tax savings when the home is later sold by the surviving spouse. The adjustment to basis varies depending on how title to the property is held. And this can make *a big difference*!

<u>Joint Tenants</u>: On the plus side, this titling has the advantage of automatically passing ownership of the property to the surviving tenant (spouse) without a will or trust. On the negative side, this titling may not be the best from an income tax perspective. In most community property states, if title to the home is held as joint tenants, there is there is a "step up" in basis equal to 50% of the fair market value on date of the spouse's death. Example: if the home is worth $400,000 when the first spouse passes, then one half or $200,000 steps up. The other half of the property retains the original cost as its basis. Let's say the original purchase price was $40,000. Then, 50% of the property's basis is $20,000. When added to the "stepped up" 50%, the new total basis is $220,000. When the home is later sold by the surviving spouse, the difference between the sales proceeds and the basis of $220,000 would be the gain. If the home were sold within 2 years of the death of the first spouse, then the gain would be tax-free if it is $500,000 or less. If the home is sold more than 2 years after the death of the first spouse, then the gain would be tax free if it is $250,000 or less. Example: the surviving spouse keeps the home for a few years before selling it for $500,000. The gain would be $280,000 ($500,000 less $220,000) and with the

$250,000 exclusion, the taxable gain to the widow is $30,000. That would have to go on the widow's income tax return for the year of the sale.

Community Property: In most community property states, the taxation upon later sale of the home would be the same as described above, with *a big exception*. If a home is considered "community property", then 100% of the property's basis steps up. Example: if the home is worth $400,000 when the first spouse passes, then that amount will be the new basis for the home. Upon later sale of the home, the gain would be the difference between the sales proceeds and $400,000. This would result in an additional $180,000 being tax sheltered versus being held as "joint tenants." Using the prior example, a sales price of $500,000 would result in a gain of $100,000 and with the $250,000 exclusion, no taxable gain. Thus, holding title as community property can save the surviving spouse significant amounts of income tax.

Some community property states now allow title to be held as "Community property with right of survivorship." Such title provides for automatic passing of ownership to the surviving spouse without probate. It also provides a 100% step up in basis. This is the best of both worlds.

Tenants in Common: When a married couple owns a home as "tenants in common," only half of the home's value will step up upon the death of a spouse. Full ownership of the deceased' portion of the home would *not* automatically go to the surviving spouse. Ownership would depend on state law and/or the deceased' will or trust.

Sole and Separate Property: In some cases, like a second marriage, this title is used. In such case, the tax basis will "step up" in full if the owner passes. So, that's good from an income tax stand point. But, there is a more important issue: who now owns the house? It might not be the surviving spouse. Ownership would be up to state law and/or the deceased' will or trust.

Since income tax and estate laws are complex and significant, you should review your home's title and local laws with a qualified tax advisor or a local attorney while both you and your spouse are living.

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