The House – Don't Ignore the Tax Consequences

By: Anju D. Jessani, MBA, APM – Accredited Professional Mediator

On August 5, 1997, President Clinton signed the Taxpayer Relief Act of 1997 into law. The scope of the legislation encompasses measures ranging from a childcare tax credit for low and moderate-income families to new tobacco taxes. The Act includes changes to the way capital gains are treated. For investments, tax rates were reduced from 15%-28% to 8%-20%, depending on income. There were also major changes in the way capital gains on homes sales will be treated for sales effective after May 6, 1997.

Previously, there were no taxes on profits if sellers bought another home within two years that cost at least as much. Buyers simply rolled the gain into their new home. Singles or married couples age 55 and older could exempt up to $125,000 of profits.

The Act allows taxpayers to exclude up to $250,000 ($500,000 in the case of a married couple filing a joint return), of gain realized on the sale or exchange of a principal residence. Taxpayers who have owned and occupied a principal residence for at least two of the five years prior to any sale may take advantage of the exclusion.

Note that if you and your spouse file a joint return for the year of the sale, you can exclude the gain if either spouse meets the ownership tests. Also, important to note is that you are considered to have used the property as your main home during any period when you owned it, and, your spouse or former spouse is allowed to use it under a decree of divorce or separation.

I have previously amended my previous article under the same name to reflect the Act. Since that time, some further clarifications were made to the article, as outlined in publication 523, "Selling Your Home." I hope it is apparent that decisions on what to do with the house will now be a little easier with the elimination of rollover requirements and one-time exclusions.

Following child custody, no issue seems to cause more emotional trauma to people getting divorced than what happens to "The House." However, many people make significant financial mistakes in dealing with the house that can prove expensive. Hopefully, after reading this article, you will be able to evaluate the various alternatives more comfortably.

At the time of the separation, one party may choose to leave the family house to reduce the ongoing hostility with the other spouse. The children tend to stay with whoever chooses to remain in the house. There is the general perception that the person who leaves reduces their chances of custody, as the other parent now has the opportunity to create a stable, familiar environment for the children. Some lawyers suggest that you don't leave... others suggest that leave only after you have a formal separation agreement which spells out parenting time and equitable distribution, including your plans for the house. An important point to note is that if you are filing under the "no fault" grounds in New Jersey, you must have lived in and maintained separate residences for at least 18 consecutive months.

Adding to the complexity of the custody issues, the house presents comfort and stability at a very difficult time. People faced with changing roles may not want to make yet another change. The house, as well as the furnishings in the house, may also represent a happier and more hopeful time in the marriage. However, sooner or later in the divorce process, at least one of the partner (and maybe both) will move, and decisions have to be made about what happens to the house.

In the course of this article, we will explore two primary tax scenarios:

Tax Scenario 1: If the house you and your spouse jointly own a primary residence that has a sales price of under $500,000, or you have under $500,000 gain, you need not worry about capital gains as long as you have both owned and occupied this as your principal residence for at least two of the five years. You own no taxes on your gain - a real gift to the middle class.

Tax Scenario 2: If you do have gains over $500,000, you will have to pay tax on the gain over $500,000 if you decide to sell the house. The maximum tax you are responsible for is 20% in addition to state taxes. If you sell the house, you can no longer defer or rollover gain.

If you have a loss on the sale of your home, you unfortunately cannot use this loss to offset other gains or to reduce the basis of any new home. However, you must report this loss on your income taxes.

In deciding what happens to the house, which we are considering your main home that is owned jointly with your spouse, some of the common alternatives we will explore in this article include:

- ***Selling the house prior the divorce***
- ***Selling the house shortly following the divorce***
- ***Agreeing to sell the house at a future date and maintaining a joint interest in the house***
- ***Transferring title to one of the parties as part of the judgment of divorce***

One other option that I won't go into detail on in this article is renting out the house you own. Please speak to your tax consultant before considering this alternative seriously. When you go to sell the house, you will be responsible for all capital gains, as the house is considered investment property rather than your primary residence. Additionally, you must now depreciate this property. This option may make sense if you anticipate a loss on the property, and/or are in a poor sales market but a strong rental market.

Selling the House Prior to The Divorce

If neither one of the partners can afford to maintain the house separately, it makes sense to try and sell the house before it becomes a financial burden. Selling the house prior to the divorce may provide needed cash for both parties, and also disposes their most expensive illiquid asset for most couples. Additionally, there is no issue as to the valuation of the house. Often, the couple may end up selling the house for less than full market value to dispose of the asset quickly; much of this is dependent on market conditions.

A real plus to this alternative is that the emotional baggage of who keeps the marital house is eliminated and both parties can move on to their own homes. Additionally, neither party needs to worry about who will make future repairs. In this situation, if there is a gain or if they have paid off a significant part of the mortgage, each party will have the necessary cash to purchase another residence or use for other purposes and start life anew. So long as you fit the criterion from Scenario 1 from above, you will not owe any taxes on capital gains. Note that you no longer need to purchase another residence or worry about rolling over gains. You get to pocket your gains immediately. A nice windfall for most divorcing couples and something that makes the division of other marital assets much simpler.

If you do have gains over $500,000, you can settle this bill quickly, and then move on with your lives. Again, as long as you have both owned and occupied this as your principal residence for at least two of the five years, you only have to pay tax on the gains over $500,000. Again, if you and your spouse file a joint return for the year of the sale, you can exclude the gain if either spouse meets the ownership tests.

Selling the House Shortly Following the Divorce

This used to be a great strategy for people getting divorce who were at 55 or above. A married couple used to be entitled to a one-time exclusion of capital gains to $125,000 at age 55, whereas single people were each entitled to exclude gain of $125,000. A lot of people in this age range waited until shortly after the divorce to dispose of the house. As the exclusion has been eliminated and the Act has also removed marriage penalties, the benefits of this strategy have, for the most part been eliminated.

The downside of waiting until after the divorce is that funds are tied up, and that any repairs to the house must be attended to. Valuation issues need to be considered, and as both parties still hold title, there has to be ongoing cooperation regarding mortgage and tax payments.

Agreeing to Sell the House at a Future Date and Maintaining a Joint Interest in the House

This is a fairly common arrangement, especially when the children may have only a few years left in school or some other significant event is impending. Typically, the divorce agreement will give one of the parties exclusive occupancy and provide that the house be sold after a certain number of years and the proceeds be divided between the ex-spouses. There are obvious benefits to this choice. The party remaining in the house (and often the children), has one less change to deal with at the time of the divorce. In addition, that party doesn't need to contend with qualifying for credit or a new mortgage at that time. On the other hand, the psychological impact of continuing to hold joint property can sometimes appear oppressive, especially as the parties go forward in forming new relationships and/or marriages.

The person staying in the house needs to be sure that they can afford to maintain the home including mortgage payments, tax payments, and repairs, until the time of the sale. There may be some arrangement that both parties participate in these payments as they both have an interest in maintaining the property. Also, failure to make payments will impact both parties credit ratings. (There is also the issue of how the gains will be shared, especially is there is a significant increase in the value of the house after the separation).

This used to be one of the most precarious of choices for the person who moved out. The rule of thumb for this person used to be that the house must have been their primary residence three of the last five years. The Act makes this choice much easier and simpler to implement and removes much of the ambiguity of the previous rules: If you and your spouse jointly own a primary residence that has a sales price of under $500,000, or you have under $500,000 gain, you need not worry about capital gains as long as you have

both owned and occupied this as your principal residence for at least two of the five years. As mentioned above, the IRS further clarified this issue in Publication 523, to say that you are considered to have used the property as your main home during any period when you owned it, and your spouse of former spouse is allowed to use it under a divorce or separation instrument. A word of warning: Make sure you have that judicial decree if you implement this option.

Transferring Title to One of the Parties as Part of the Judgment of Divorce

When there are sufficient funds, or assets to offset the value of the house, transferring title to one of the parties may happen. This occurs more frequently when one party has a large pension or has a business that they want to retain for themselves and the other spouse receives the house. Because the house may serve as a reminder of the marriage, or the failure of the marriage to one or both of the parties, the psychological impact of the this alternative must also be evaluated in the decision making process.

Again, the most obvious benefit to the person remaining in the house is that they need to make one less change in their lives, and don't have to worry about qualifying for a new mortgage. On the other hand, a deed needs to be executed, transferring the property. Depending on how the paperwork is done, the mortgage may remain in both parties' names.

Safeguards need to be put in place to ensure that payments are made in a timely manner. If it is possible, it is preferable that the mortgage also be transferred to the person retaining ownership of the house. The person retaining the house should be sure that they can afford the house by themselves before making the decision to keep the house, and to also ensure that the family house still meets their needs as a single person.

The issue of establishing a price for the house can be contentious. Experts generally agree that it makes sense to have three real estate brokers provide a realistic estimate. Additionally, there is the question of whether sales expenses amounting to approximately 7% should be deducted from the sales price to obtain the net sales price. Generally, this is done more often, but not always.

Before you choose this alternative, you should consult with a tax consultant, especially if you have a large gain on the house.

- ***The person who retains ownership of the house will be responsible for the entire gain on the house, when it is time to sell the house. This could prove to be a problem if the projected gain will be over $250,000, the maximum real estate gain a single person can exclude.***
- ***The person who transfers their share of the house to a spouse or ex-spouse, is no longer responsible for capital gains. They may not have made this decision had they realized that their ex would be saddled with a tax liability if the gain was the gain was over $250,000 . This holds especially true in your more amicable type divorce.***

Good Luck

The bottom line of what happens to the house is that it depends. Good luck with whatever you do. Remember a house is just a building. You make your home by bringing your warmth, love, and personality to an inanimate structure. Just make sure that you incorporate tax planning in your decision making, because the IRS is especially diligent in examining the tax returns of the newly divorced.

Copyrighted by: Anju D. Jessani, MBA, APM - Accredited Professional Mediator
For more Information, please contact ajessani@dwdmediation.org