Money Matters

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Skloff Financial Group Question of the Month

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Q: We read 'How a Gift Can Be a Tax Dream or a Tax Nightmare' Part 1 and Part 2. We also read 'How To (Legally) Avoid Taxes When Selling Your Home' Part 1, Part 2 and Part 3. Furthermore, we read 'How Gifting Versus Selling Your Home Can Be a Tax Dream or a Tax Nightmare' Part 1, Part 2 and Part 3. Lastly, we read 'How a Step-Up in Basis Can Be a Tax Dream' Part 1. Can you give examples of the tax implications of a step-up in basis?

The Problem – A Step-Up in Basis Can Be Confusing
From income taxes to capital gains taxes to investment surtaxes in the form of the Net Investment Income Tax (NIIT), it's no wonder the tax code is so confusing. Understanding a step-up in basis adds one more layer of confusion.

The Solution – A Side-by-Side Comparison of Gifting, Then Selling Versus Inheriting with a Step-Up in Basis
If you and your spouse gift your home to your child and their spouse, you also gift them **your** cost basis (or Adjusted Basis) and **your** holding period, which becomes **their** cost basis (or Adjusted Basis) and **their** holding period. Upon sale, the holding period is based on the combined holding period (the amount of time you owned it plus the amount of time they owned it). In the examples below: 1. You and your spouse have a $100,000 cost basis and 2. The home does not become the primary residence of your child and child's spouse.

Gifting Your Home to Your Child and Child's Spouse, Then They Sell It with a Combined Ownership of 1 Year or Less
If they sell the home for $1,100,00, they would realize a $1,000,000 short term capital gain ($1,100,000 selling price - $100,000 cost basis) at their 37% marginal income tax bracket, resulting in $370,000 ($1,000,000 X 37%) of income taxes plus NIIT of $38,000 ($1,000,000 X 3.8%). Their total taxes would be $408,000, leaving them with $692,000 of proceeds net of taxes – **a tax nightmare**. See the red (danger zone) section of the table below.

Gifting Your Home to Your Child and Child's Spouse, Then They Sell It with a Combined Ownership of More Than 1 Year
If they sell the home for $1,100,00, they would realize a $1,000,000 long term capital gain ($1,100,000 selling price - $100,000 cost basis) at their 20% capital gains rate, resulting in $200,000 ($1,000,000 X 20%) of capital gains taxes plus NIIT of $38,000 ($1,000,000 X 3.8%). Their total taxes would be $238,000, leaving them with $862,000 of proceeds net of taxes – **a tax nightmare**. See the yellow (safe zone) section of the table below.

Having Your Child and Child's Spouse Inherit Your Home, Then They Sell It Immediately
If they inherit the home, they would receive a step-up in basis to the fair market value of the home on your date of death, which is $1,100,000. If they immediately sell the home for $1,100,000, they would be exempt from taxes – **a tax dream**. The step-up in basis would have saved them $408,000 in taxes versus the first scenario and $238,000 versus the second scenario. See the green (ultra safe zone) section of the table below.

Gifting Your Home To Your Child and Child's Spouse, Then They Sell It Versus They Inherit It, Then They Sell It			
	Gifting Then Selling with Combined Ownership of 1 Year or Less	Gifting Then Selling with Combined Ownership of More Than 1 Year	Inherit and Sell Immediately
Selling Price	**$ 1,100,000**	**$ 1,100,000**	**$ 1,100,000**
Cost Basis or Adjusted Basis	$ 100,000	$ 100,000	$ 1,100,000
Net Capital Gain	**$ 1,000,000**	**$ 1,000,000**	**$ 0**
Income Tax 37%	$ 370,000	$ 0	$ 0
Long Term Capital Gains Tax 20%	$ 0	$ 200,000	$ 0
Net Investment Income Tax (NIIT) 3.8%	$ 38,000	$ 38,000	$ 0
Total Taxes	$ 408,000	$ 238,000	$ 0
Proceeds Net of Taxes	**$ 692,000**	**$ 862,000**	**$ 1,100,000**

Action Steps
Work closely with your Registered Investment Adviser (RIA) to reduce your taxes, and grow and preserve your wealth.

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