Volume 8, Issue 1

March 2016

DUMONT & BLAKE
INVESTMENT ADVISORS

731 Alexander Road, Suite 301
Princeton, New Jersey 08540

609-514-1899 800-345-3200
609-514-4222 Fax

Money In Motion

www.dumontandblake.com

Explaining the Basis of Inherited Real Estate

What is cost basis? Stepped-up basis? How does the home sale tax exclusion work?

At some point in our lives, we may inherit a home or another form of real property. In such instances, we need to understand some of the jargon involving inherited real estate. What does "cost basis" mean? What is a "step-up?" What is the home sale tax exclusion, and what kind of tax break does it offer?

Very few parents discuss these matters with their children before they pass away. Some prior knowledge of these terms may make things less confusing at a highly stressful time.

Cost basis is fairly easy to explain. It is the original purchase price of real estate plus certain expenses and fees incurred by the buyer, many of them detailed at closing. The purchase price is always the starting point for determining the cost basis; that is true whether the purchase is financed or all cash. Title insurance costs, settlement fees, and property taxes owed by the seller that the buyer ends up paying can all become part of the cost basis.[1]

At the buyer's death, the cost basis of the property is "stepped up" to its current fair market value. This step-up can cut into the profits of inheritors should they elect to sell. On the other hand, it can also reduce any income tax liability stemming from the transaction.[2]

Here is an illustration of stepped-up basis. Twenty years ago, Jane Smyth bought a home for $255,000. At purchase, the cost basis of the property was $260,000. Jane dies and her daughter Blair inherits the home. Its present fair market value is $459,000. That is Blair's stepped-up basis. If Blair sells the home and gets $470,000 for it, her complete taxable profit on the sale will be $11,000, not $210,000. If she sells the home for less than $459,000, she will take a loss; the loss will not be tax-deductible, as you cannot deduct a loss resulting from the sale of a personal residence.[1]

The step-up can reflect more than just simple property appreciation through the years. In fact, many factors can adjust it over time, including negative ones. Basis can be adjusted upward by the costs of home improvements and home additions (and even related tax credits received by the homeowner), rebuilding costs following a disaster, legal fees linked to property ownership, and expenses of linking utility lines to a home. Basis can be adjusted downward by property and casualty insurance payouts, *(continued on page 2)*

Saving for College and Retirement

Saving for retirement is a must. Saving for college is certainly a priority. How do you do both at once?

1) Saving for retirement should always come first. After all, retirees cannot apply for financial aid; college students can. That said, there are ways to try and accomplish both objectives within the big picture of your financial strategy.

2) As a first step, whittle down household debt. True, some debts are not easily reduced, and some are worth assuming, but many are byproducts of our wants rather than our needs. NerdWallet, a personal finance website, notes that the average U.S. household now carries *credit card debt* of more than $15,000. Less revolving consumer debt means more money available to potentially direct toward a retirement fund and a college fund.[1]

3) See if your children have a chance to qualify for need-based financial aid. Impossible, you say? You may be surprised. You can have one million dollars in your IRA or your workplace retirement plan and not impact your child's potential for need-based financial aid one iota. That is because those retirement accounts are not considered parental assets in the calculation of the Expected Family Contribution (EFC) that factors into determining a student's need.[2]

That "need" is determined through a basic equation: the cost to attend the school minus the EFC equals the financial need of the student. So, in theory, the lower you can keep your EFC, the more need-based financial assistance your student deserves.[2]

The Free Application for Federal Student Aid (FAFSA) and College Board CSS/Financial Aid PROFILE use slightly different calculation methods to determine the EFC, both student and parental assets factor into the calculation. What usually counts most is the income of the parent(s), minus some taxes, tax deductions, and allowances. Capital gains from investment accounts can qualify as "parent income," and so can Roth and traditional IRA distributions.[2,3]

Money held *inside* a qualified retirement plan, though, is not included in need analysis formulas. Life insurance cash values rarely count. Most Coverdell ESAs and UGMA *(continued on page 2)*

Saving for College and Retirement *(continued from page 1)*

and UTMA accounts represent assets owned by the child, and child assets receive 20% weighting in EFC calculations (parental income receives up to 47% weighting). Parental assets, as opposed to parental income, are weighted at no more than 5.64% yearly. Cash and brokerage accounts are considered parental assets; so are student-owned 529 plans. Even real estate investments can be defined as parental assets.[3,4]

The CSS PROFILE form does inquire about retirement account values and life insurance cash values, but they are not factored into the EFC calculation. They may be considered if a college financial aid officer needs to make an assessment of the overall financial health of a household pursuant to a financial aid decision.[2]

4) What if your kids have little or no chance to receive financial aid? Then scholarships and grants represent the primary routes to easing the tuition burden. So save for retirement as well as you can and save for college in a way that promotes the best after-tax return on your investment. Feel free to max out your workplace retirement plan contribution (and get the match from your employer). If you do so, the impact on your child's eligibility for college aid would be negligible. If you have a Roth IRA or permanent life insurance policy, think about the ways they can be used in college planning as well as retirement and estate planning. You may be able to tap a life insurance policy's cash value to

pay some college costs, and distributions from a Roth IRA occurring before age 59½ are exempt from the standard 10% early withdrawal penalty if they are used for qualified educational expenses.[5]

5) Even if your household is high-income, look at the American Opportunity Tax Credit. The AOTC is a federal tax credit of up to $2,500 per year that can be applied toward qualified higher education expenses. It is better than a federal tax deduction, as it lowers your federal income tax dollar-for-dollar.

If you are married and you and your spouse file jointly, you are eligible to claim the AOTC if your modified adjusted gross incomes total $180,000 or less. If you are a single filer, you are eligible if your modified adjusted gross income is $90,000 or less. Phase-out ranges do kick in at $160,000 for joint filers and $80,000 for single filers.[6]

Citations
1 - dailyfinance.com/2016/03/23/8-financial-decisions-youll-regret-forever/ [3/23/16]
2 - forbes.com/sites/troyonink/2016/02/29/balancing-act-strategically-saving-for-college-and-retirement/ [2/29/16]
3 - money.usnews.com/money/blogs/the-smarter-mutual-fund-investor/articles/2016-03-18/strategies-to-maximize-college-savings-and-financial-aid [3/18/16]
4 - finaid.org/savings/accountownership.phtml [4/6/16]
5 - irs.gov/Retirement-Plans/Plan-Participant,-Employee/Retirement-Topics-Tax-on-Early-Distributions [2/22/16]
6 - irs.gov/Individuals/AOTC [12/8/15]

Explaining the Basis of Inherited Real Estate *(continued from page 1)*

allowable depreciation that comes from renting out part of a home or using part of a residence as a place of business, and any other developments that amount to a return of cost for the property owner.[1]

The Internal Revenue Code states that a step-up applies for real property "acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent." In plain English, that means the new owner of the property is eligible for the step-up whether the deceased property owner had a will or not.[2]

In a community property state, receipt of the step-up becomes a bit more complicated. If a married couple buys real estate in Arizona, California, Idaho, Louisiana, New Mexico, Nevada, Texas, Washington, or Wisconsin, each spouse is automatically considered to have a 50% ownership interest in said real property. (Alaska offers spouses the option of a community property agreement.) If a child or other party inherits that 50% ownership interest, that inheritor is usually entitled to a step-up. If at least half of the real estate in question is included in the decedent's gross estate, the surviving spouse is also eligible for a step-up on his or her 50% ownership interest. Alternately, the person inheriting the ownership interest may choose to value the property six months after the date of the previous owner's death (or the date of disposition of the property, if disposition occurred first).[2,3]

In recent years, there has been talk in Washington of curtailing the step-up. So far, such notions have not advanced toward legislation.[4]

What if a parent gifts real property to a child? The parent's tax basis becomes the child's tax basis. If the parent has owned that property for decades and the child cannot take advantage of the federal home sale tax exclusion, the capital gains tax could be enormous if the child sells the property.[2]

Who qualifies for the home sale tax exclusion? If individuals or married couples want to sell an inherited home, they can qualify for this big federal tax break once they have used that home as their primary residence for two years out of the five years preceding the sale. Upon qualifying, a single taxpayer may exclude as much as $250,000 of gain from the sale, with $500,000 being the limit for married homeowners filing jointly. If the home's cost basis receives a step-up, the gain from the sale may be small, but this is still a nice tax perk to have.[5]

Citations
1 - nolo.com/legal-encyclopedia/determining-your-homes-tax-basis.html [3/30/16]
2 - realtytimes.com/consumeradvice/sellersadvice1/item/34913-20150513-inherited-property-understanding-the-stepped-up-basis [5/13/15]
3 - irs.gov/irm/part25/irm_25-018-001.html
4 - blogs.wsj.com/totalreturn/2015/01/20/the-value-of-the-step-up-on-inherited-assets/ [1/20/15]
5 - nolo.com/legal-encyclopedia/if-you-inherit-home-do-you-qualify-the-home-sale-tax-exclusion.html [3/31/16]