The Widow Trap

One of the unfortunate but inevitable situations we will face is the death of a spouse. Obviously, this will create changes – big changes. One of those: does the surviving spouse move to a smaller home or a retirement facility, and if so, when? Most psychologists and counselors advise against making big changes for some time following the death of a spouse. This seems to make sense from a mental wellness stand point. However, our tax system is not so understanding.

You may be aware of the Federal income tax rule that allows a portion of the gain upon sale of a principal residence to be tax free. 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 in the year of the death of the spouse or in the year following that year. Example: a spouse passes away in 2016. The surviving spouse is entitled to the $500,000 exclusion if the home is sold in 2016 or 2017. 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.

A few years ago, I had a new client that asked me to do her tax return after she sold her home. She and her husband had purchased their home in a middle class neighborhood in the late 1960s for $30,000. The husband passed away in 2005 when the fair market value of the home was $400,000. Since the home was jointly owned in a non-community property state, the basis (cost) of the home for tax purposes was adjusted to $215,000 (½ of original cost plus ½ of fair market value on date of death). In 2010, the widow decided to move to a multi-level retirement facility and she sold her home. She sold it for $812,000. That meant her gain was $597,000 ($812,000 less $215,000). Since it had been more than two years since her husband passed, her exclusion amount was $250,000. That meant that her taxable capital gain was $347,000 ($597,000 less $250,000). Although her normal annual income was a modest $60,000 (Social Security, a pension and interest), her one time annual income jumped to $407,000. That's in the territory of what some politicians call "rich". At the $400,000 income level, the tax rules get very complex and the tax rates get very high. Even though the increase in value in her home took place over several decades, the government taxes the gains as if they took place in one year.

And worse still, recent tax changes have made the taxation on the sale of a home even higher than they were in 2010. Here are some things that will happen:

1. The usual capital gains tax rate of 15% jumps to 20%
2. The Obamacare investment gains tax kicks in to add another 3.8% (total 23.8%)
3. Personal Exemptions are reduced
4. Allowable Itemized Deductions are reduced,

5. Alternative Minimum Tax kicks in.
6. The top tax rate on other income (like a pension and Social Security) rises to 39.6%
7. Other deductions and credits are lost or limited.
8. Underpayment of estimated tax penalties may apply.
9. Two years after the sale of the home, Medicare premiums will more than triple. That's right, they even tax you through higher Medicare premiums!

If you live in a state that has state income tax, high rates of taxation will be added to the above. The combined marginal Federal and state income tax rate can hit 50%; a real tax nightmare.

Unfortunately, there are no perfect solutions to this dilemma. Should the new widow/widower move within two years of their spouse's death? Or, should the surviving spouse remain in his/her home for the rest of their life? How about an installment sale? How about converting the residence into a rental property? Should the home be gifted to a son or daughter with a leaseback? All options have their drawbacks. But it's important to understand the problem and alternatives, and then tailor a solution that best fits your own needs. You should review your options with a qualified tax advisor before you sell your home. Asking for advice after a sale has taken place will provide few options.

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