Gain exclusion may be affected by holding a residence in a trust

TRUSTS: How does holding a personal residence in a revocable trust affect eligibility for the $250,000 or $500,000 home-sale exclusion?

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If a taxpayer sells a personal residence, $250,000 of the gain on the sale ($500,000 for a married couple filing a joint return) may be excluded from income if, during the five-year period ending on the date of sale, the property was owned and used by the taxpayer as a personal residence for periods totaling at least two years.[1] A common estate planning technique to avoid probate is to transfer a personal residence into a revocable trust.

These two concepts can, however, run afoul of one another if the owner of the residence dies. If the home is later sold by the trust, how does this affect the home-sale exclusion?

Is the exclusion available?

In general, grantor trusts are ignored for income tax purposes and the grantor or owner of the trust that holds the property is treated as the owner of the property.[2] If a residence is held by a trust, then the taxpayer will still qualify for the home-sale exclusion so long as he or she is treated as the owner of the trust under the grantor trust rules.[3]

When both spouses are living, the revocable trust is normally treated as a grantor trust, so the spouses will most likely qualify for the home-sale exclusion. When one spouse dies, and if the residence is allocated to either the bypass trust or the marital trust in either the A-B trust or A-B-C trust situation, then there could be a problem if the residence is later sold by one of these trusts because the bypass trust and the marital trust are not ordinarily treated as grantor trusts and don't qualify for the home-sale exclusion.[4]

If the residence (or a portion thereof) has been allocated to the bypass trust or the marital trust, and is sold soon after the first spouse's death, then there will probably be little or no gain on the sale because the tax basis of the home (or portion thereof) has been "stepped up" to fair market value.[5] However, if the surviving spouse continues to live in the residence and it appreciates in

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How does a revocable trust operate?

A taxpayer commonly holds a personal residence in a revocable trust in order to avoid probate. Probate is the legal process by which title to a decedent's assets is transferred to his or her heirs. Through probate, a court makes sure that the decedent's will is legally valid, that the decedent's debts are paid, and that the assets are distributed according to the will.

The probate process is something to avoid because it is expensive, takes time, and is public. For example, in California, probate fees can be 3% to 4% of the gross value of the estate. The probate process can take up to two years, and during this time, the decedent's assets often can't be distributed. Documents filed in probate proceedings are matters of public record and can be inspected by anyone who is interested.

Not everything that a decedent owns needs to go through probate. Assets that are jointly owned or that have a designated beneficiary (such as an insurance policy or an IRA) usually avoid probate. Assets that have been transferred to a trust also avoid probate. Having a revocable trust to hold assets has become a popular way to avoid probate.

When an individual establishes a revocable trust, the trust document includes the provisions that would ordinarily be contained in the individual's will. After establishing the trust, ownership of the individual's assets is transferred to the trustee of the trust. Upon the individual's death, the terms of the trust document explain what to do with the trust assets. Probate is avoided because it isn't necessary for a probate court to interpret the will for disposition of the trust assets.

A revocable trust for a married couple is typically structured as either an A-B trust or an A-B-C trust. Both of these trusts provide that while the husband and wife are both living, the assets are retained in a single trust for the benefit of both spouses.

With the A-B trust, when the first spouse dies, the trust assets are divided into two subtrusts: a survivor's trust (the A trust) and a bypass trust (the B trust). The survivor's trust is revocable and treated as a grantor trust, while the bypass trust is irrevocable and not treated as a grantor trust.

The purpose of the bypass trust is to ensure full usage of the estate tax exemption which is currently $1.5 million. Each spouse is entitled to this exemption, and when the first spouse dies, up to $1.5 million of the decedent's assets is placed in the bypass trust. The surviving spouse has the use of these assets and is usually the trustee of the bypass trust. The survivor's trust contains all of the surviving spouse's assets and the deceased spouse's assets that were not allocated to the bypass trust.

With the A-B-C trust, when the first spouse dies, the trust assets are divided into three subtrusts: a survivor's trust (the A trust), a bypass trust (the B trust) and a marital trust (the C trust). Like the bypass trust, the marital trust is irrevocable and not treated as a grantor trust.

The survivor's trust and the bypass trust work the same way as the A-B trust except that the deceased spouse's assets in excess of the estate tax exemption (i.e., in excess of $1.5 million) are now placed in the marital trust rather than in the survivor's trust, and the survivor's trust contains only the surviving spouse's assets .

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value, its later sale by the bypass trust or marital trust may result in a sizeable taxable gain, and no home-sale exclusion will be allowed.

One solution to this problem is to allocate the residence to the survivor's trust rather than the bypass trust or marital trust. A sale of the residence will then qualify for the home-sale exclusion because the survivor's trust is normally treated as a grantor trust.

However, it may not be possible or desirable to allocate the residence to the survivor's trust for various estate-planning reasons. For example, if the married couple lives in a community-property state, one-half of the couple's community property and the surviving spouse's separate property will usually be allocated to the survivor's trust. If the residence is community property, then only one-half of the residence will qualify for the home-sale exclusion.

If the residence (or a portion thereof) has been allocated to the bypass trust or marital trust, then the surviving spouse (or survivor's trust) could purchase the residence (or that portion) from the bypass trust or marital trust. The surviving spouse could accomplish this purchase in an arm's-length transaction by giving a note to the appropriate trust.[6] A surviving spouse who intends to continue residing in the home could then satisfy the two-year ownership-and-use test and qualify for the home-sale exclusion.

Conclusion

Although holding a residence in a revocable trust is a popular way to avoid probate, it can cause a problem with the IRC §121 home-sale exclusion upon the death of one spouse. There are two solutions to this problem that could still permit the surviving spouse to claim the home-sale exclusion when the residence is subsequently sold. Making sure that the surviving spouse (or the survivor's trust) has owned the residence for at least two years prior to the sale, and that the surviving spouse has satisfied the other requirements of §121, will preserve the home-sale exclusion. §

1 IRC §121(a)

2 IRC §§671 – 679

3 See Treas. Regs. §1.121-1(c)(3)(i), Rev. Rul. 66-159, 1966-1 C.B. 162, Rev. Rul. 85-45, 1985-1 C.B. 183 and IRS Letter Ruling 199912026 (Mar. 29, 1999) (sale of a home by a trust treated as a grantor trust qualifies for the home-sale exclusion)

4 See Lee T. Reams, "Home Sale Exclusion," 23 EA Journal No. 1, p. 7, 15 (Nat'l Assoc. of Enrolled Agents, Jan./Feb. 2005). See also IRS Ltr. Rul. 200104005 (Jan. 29, 2001) (no home-sale exclusion for sale of residence held in a Bypass Trust except for portion for which surviving spouse exercised his "five or five" power to withdraw trust corpus)

5 IRC §1014(a)(1), (b)(1) and (b)(6). This assumes that no fractional discount has been claimed in valuing the residence for estate tax purposes. If a portion of the residence has been allocated to the Bypass Trust or the Marital Trust, a fractional discount may have been taken for estate tax purposes. See, e.g., ***Propstra v. United States*** (9th Cir. 1982) 680 F.2d 1248.

6 The note may require only periodic payments of interest with a balloon payment at the end of the term so long as the interest rate is at least the Applicable Federal Rate. See IRS Ltr. Rul. 9535026 (May 31, 1995).

7 The trust document can be drafted to ensure that the assets are not later subject to estate tax when the surviving spouse dies, even if they appreciate in value.

8 The main purpose for establishing a Marital Trust is one of control. The trust document will frequently provide that assets placed in the Marital Trust are distributed to the children upon the surviving spouse's death.

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