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Legal Matters®

Estate Planning
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When to sell your parents' home: The tax consequences

Let's say you've known for years that you are inheriting your father's home when he dies.

Hopefully, you also know that he has a will that indicates clearly that the house will go to you.

Now let's assume that your father is no longer living in the house and doesn't need the money from the sale. Perhaps he just moved to assisted living and has long-term care insurance to cover the costs. Or maybe he just moved in with you and has enough retirement savings to cover his needs.

When a home is inherited after someone dies, the property value is "stepped up" to the fair market value at the time of death.

So when is the best time for your dad's house to be sold: While he is still alive or after he dies?

Let's consider the tax implications of the sale. As long as your dad has lived in his house for two of the last five years, it's considered his primary residence under the Internal Revenue Code. That means that he can take advantage of the federal exclusion on capital gains tax. An individual taxpayer does not have to pay capital gains tax on the first $250,000 gain in the value of his or her home. A married couple does not have to pay capital gains tax on up to $500,000 in gains.

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Assume the house was purchased for $25,000 in 1977. It's now 2020 and it's worth $825,000.

So far, that sounds great. Your dad stands to make an $800,000 profit.

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Tips for succession planning

The longevity of a small business depends on a well-thought-out succession plan.

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For a family business, you want to evaluate who else can run the business and whether you have to look beyond family members as the business grows.

An experienced attorney can help the key stakeholders create a succession plan or review your existing plan.

If you want to choose a successor, here is a basic how-to-guide to help you get started:

1) Think about who your successor should be. This is an important decision that shouldn't be taken lightly, and should be on your radar at least 15 years before you expect to retire. Consider who within the business is most qualified to lead going forward. Get some professional guidance, especially if you have a family business, where emotions run high in transitions.

2) Create a timeline. Decide well in advance when the control of the business will shift to your successor. Be flexible and open to your successor's suggestions and ideas for the business during the transition.

3) Set up a training plan. Define the main areas of the company, and give your successor time to work in all of them, from the highest executive level parts of the business to the most basic tasks. Work with your successor to strengthen his or her understanding in any areas of difficulty.

4) Lay out your own plans for retiring. Having a plan for your retirement will make succession much easier and give both your successor and other members of the team clarity about what's next and when.

5) Execute the plan and exit. When the time comes, step aside to allow the next leader to take over.

Other choices for succession planning

Handing over company leadership to a successor is only one option. Here are some other ways to go about planning for the long-term success of your business after you exit:

Find a buyer. Sell your interest in the company in exchange for cash or other assets. Bear in mind that you might have to pay capital gains tax.

Transfer your interest by agreement. Consult with an attorney to draft a buy-sell agreement that plans for the sale of your interest in the business at a certain time. The buyer agrees to purchase your business interest at fair market value if and when the indicated event occurs, such as at death, when you retire, if you become disabled, or if you get divorced.

Create a Family Limited Partnership for the business. It can be beneficial to create a Family Limited Partnership (FLP) and transfer a family business to it. An FLP is an entity owned by two or more family members that allows each member to buy shares of the business and to transfer assets between family members tax-free. It includes both general and limited partners. General partners bear 100 percent of the liability and control all management and investment decisions, while limited partners don't have full voting power and don't share liability. When one family member is ready to leave the business, it's easy to transfer it to another.

Set up a private annuity. A private annuity allows you to transfer your business interest to a family member or another buyer in exchange for his or her agreement to make periodic payments to you for the rest of your life, or through the lifetime of a surviving spouse. A private annuity has the benefit of avoiding gift and estate taxes.

Transfer your business interest to an irrevocable trust. If you create an irrevocable trust, such as a Grantor Retained Annuity Trust (GRAT) or a Grantor Retained Unitrust (GRUT), you can transfer your business interest into the trust while continuing to receive income for a defined period. When the time period elapses or you die, your interest in the business goes to the beneficiary of the trust.

Transfer your interest using a self-canceling installment note (SCIN). An SCIN is used to transfer value out of an estate with no gift tax cost. Through an SCIN, you can transfer your business to a buyer in exchange for a promissory note with a "self-cancellation" provision. The promissory note requires the buyer to make a series of payments to you until you die, at which point the note and the outstanding balance are both canceled. At that time, the remaining balance is transferred to the buyer tax-free, with no additional payment owed.

Don't forget to fund your trust

Most people who have an estate plan have created a trust. But one thing many people forget is rather important: funding the trust.

During the lifetime of the grantor who created the trust, the trustee can use the trust assets for the grantor's benefit, if the grantor becomes incapacitated.

If you want the trustee to do that, you must be sure your trust is funded.

To fund the trust during your lifetime, you must change the title of any assets you own to the trustee. Assets might include real estate, bank accounts, stock and mutual fund accounts and/or businesses. In some cases, you, as the grantor, will also be the owner of the trust. The new title would then say that the grantor owns the trust as the trustee.

Another option is funding your trust at your death by making your trust the beneficiary of certain assets, such as retirement accounts and life insurance proceeds.

When you pass, the assets in the trust are administered for the benefit of your beneficiaries, who are named in the trust. Your will should state that your remaining assets will go into the trust. That way, you avoid your beneficiaries going through a long probate process to administer your assets.

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When to sell your parents' home: The tax consequences

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He won't have to pay capital gains tax on the first $250,000 in gains. But the tax will be applied to the $550,000 profit after the exemption. Also, in some states additional taxes would be owed.

Keep in mind that the situation looks different if your dad's house is worth a lot less money, or if both of your parents are still alive. For a house with a gain of $250,000 or less ($500,000 or less for a married couple), your dad will avoid paying capital gains tax entirely if all conditions are met. Then, the amount of tax due on the sale could be relatively small, so your dad could choose to sell now and leave the proceeds to you at death.

Selling after death

When you sell the home after your dad passes, another highly beneficial rule comes into play — the step-up in basis at death rule. Under that rule, when a home is inherited after someone dies, the property value is "stepped up" to the fair market value at the time of death.

Take the example of your dad's house. At his death, the Internal Revenue Code views the $800,000 gain in property value as the value of the property, rather than a taxable profit. That means you keep the money in your pocket when you sell it.

Generally, with a house that is likely to show a large gain you are better off encouraging a parent to leave the house to you so you can sell it when he or she passes.

Other things to keep in mind

If you wait to sell your dad's house after he dies, the probate process could take several months or more. You can't sell the house until it's distributed to you after probate. Depending where you live and how much time passes, that means the house could increase in value before you sell. You will have to pay capital gains tax on the profit, because at that point your dad's house is treated as your second home and doesn't qualify for the federal exclusion on a primary residence.

There are a few ways to speed up this process, if you have the chance to help your parents make plans during life.

If your dad leaves his home to you in a revocable living trust that names you as the beneficiary, you won't need to go through probate, can avoid some estate taxes and are in a position to sell the home right after your parent(s) dies.

Another option is a transfer on death deed, which is only available in certain states. This allows you to inherit the property right away, without going through probate. But you will still have to pay taxes on the house.

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Borrowing from your retirement due to COVID-19

When you save for retirement, the goal is to keep the money growing until you are of retirement age. But sometimes unexpected financial crises arise, as is the case with many people due to the pandemic.

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The CARES Act, which was signed into law in March, offers some relief with expanded withdrawals from IRAs and retirement plans and expanded loan options from certain retirement plans.

You are eligible for these relief options if you, your spouse or another member of your household:

•Is diagnosed with COVID-19.

•Suffers adverse financial consequences as a result of COVID-19. That might include being quarantined or furloughed, having work hours reduced, having a reduction in income, or having a job offer delayed or rescinded.

•Has a business they own or operate close or require reduced hours due to COVID-19.

Under the law, eligible individuals may be able to withdraw up to $100,000 from their IRA or workplace retirement plan before Dec. 31, 2020, assuming it's allowed under their plan.

The CARES Act, which was signed into law in March, offers some relief.

Such withdrawals will not incur the 10 percent penalty that typically applies to withdrawals before age 59 1/2. You may choose to have the withdrawal included in your taxable income over a three-year period, or in the year you make the withdrawal.

The withdrawals are not subject to mandatory tax withholding, and they may be repaid to your IRA or retirement plan within three years.