# STRATEGIC USE OF THE EXCLUSION ON THE SALE OF ONE'S RESIDENCE, THE INSTALLMENT SALE METHOD, AND THE 0 PERCENT CAPITAL GAINS TAX RATE CAN YIELD AMAZING SAVINGS

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## ABSTRACT

Careful planning to take advantage of generous tax provisions, especially when two or more can work simultaneously, can have overwhelming results. This analysis considers what happens when taxpayers are able to simultaneously benefit from the exclusion on the sale of one's principal residence, the 0 percent capital gains tax rate, and installment sale treatment. In the unique example presented here, the gain on the sale of a million dollar residence avoids income tax. Interest and 85 percent of Social Security benefits are taxed as ordinary income.

## INTRODUCTION

Fortunately, for professional tax practitioners, and their clients, many sections of the Internal Revenue Code (Code) were passed into law by Congress in isolation, without examination of all of their possible interactions with other sections of the Code. Therefore, at times advantages that were not contemplated by Congress can be obtained for clients by combining these different sections to solve a particular tax problem and reduce or eliminate the client's tax liability. In this paper we examine two Code provisions that can be utilized along with the installment sale rules to reduce or eliminate the potential tax liability that was intended with the passage of other sections of the Code.

## SUMMARY OF CONTROLLING TAX LAWS

The three provisions that are detailed here are benefits provided for different target groups at different times. Like any provision, they are subject to change at Congress's discretion,

The first provision is the exclusion of gain on the sale of one's principal residence. Prior to 1998, one could defer gain on the sale of a residence by reinvesting as much or more in a replacement residence within two years [repealed Internal Revenue Code (hereinafter, IRC) § 1034]. Taxpayers who were at least 55 years of age could exclude gain of up to $125,000 once in their lifetimes [former IRC § 121]. This was replaced by the current exclusion under § 121 which allows one to exclude up to $250,000 on the sale of any principal residence owned and used for at least two years in the five years preceding disposition. For married couples, up to $500,000 can be excluded if both spouses used, and one owned, the residence as their principal residence for the required two years. Significant for this analysis, is the fact that there was no limit under repealed IRC § 1034, and the current § 121 limit may not be enough for those with high-end housing.

The second provision is the zero percent tax rate on certain capital gains. When Congress deliberated the then 20 percent, currently 15 percent, preferential rate on most net long-term capital gains, some commentators asserted that such a provision disproportionately benefited high-income individuals. In response, Congress provided a 5 percent, currently 0 percent, rate for any such gains falling into the 15 percent, currently 10 percent and 15 percent, tax bracket. Currently, the 15 percent and 0 percent rates are scheduled to revert to 20 percent and 10 percent, respectively, on January 1, 2013. Congress has tended to extend or revise such rates in recent experience, often at the last minute, when under political pressure [see IRC § 1(h)], so only time will tell.

Planning is treacherous when one forecasts tax rates and other tax laws. Looking at 2012, the 15 percent tax bracket tops out at $70,000 for married individuals and $35,350 for single individuals. This, of course, is taxable income, so a married couple with no dependents could have AGI of up to $90,200 ($70,700, plus $11,900 standard deduction, plus two $3,800 personal exemptions), more if they itemized their deductions, and still be within the 10 and 15 percent tax brackets, resulting in their 15 percent gains being taxed at 0 percent. For a single taxpayer, the equivalent amount is $45,100 ($35,350 + $5,950 + $3,800).

The third provision that can apply is the timing of installment sale reporting. Any recognizable gain can be spread over the years in which principle payments are received [IRC § 453]. Sellers can arrange the timing of the principle payments to their advantage if the buyer will cooperate. In fact, the greatest advantage of the tax rates can be achieved by timing of income and deductions so as to gain the most desirable outcome.

In summary, unlimited concepts used in tax planning might be used to effectuate the types of benefits discussed here. In addition to timing of principle payments received, interest payments received on an installment sale and interest paid on other obligations can be timed, in addition to state and local tax obligation payments being made at strategic times. Further, taxpayers can manage the timing of capital gain and loss recognition on dispositions of other assets, along with other simple, and more complex (including when to start taking Social Security benefits), planning scenarios.

The risks, and potential benefits, of unknown, and somewhat unpredictable, changes in the tax law cannot be over emphasized. Taxpayers must continuously be made aware of the vulnerabilities.

## COMPREHENSIVE EXAMPLE

This example illustrates the strategic use of installment sale to minimize capital gains tax on the sale of a super-appreciated home to taxpayers' children.

Frank and Julie Homeowner acquired their home in Southern California in 1980 for $200,000. In 2011, when all of their children had graduated from college and were successfully settled in to their careers and families, Frank and Julie, now both age 56, decided that they would like to move to a smaller more modest house and prepare for their retirement when they would reach their normal retirement age of 66. Fortunately, the Homeowners had been able to pay off the mortgage during the thirty years they spent raising their family in the home; therefore, they had 100 percent equity in the current $1,200,000 market value. Additionally, their daughter Susan and her husband, who had just added a set of triplets to the twins that had been born two years earlier, expressed a desire to buy the home for their now large family if they could get some help in the financing.

A major problem facing the homeowners was that, although they met the requirements for excluding $500,000 of the gain, the other $500,000 would be subject to 15 percent federal and approximately 10 percent California capital gain taxes resulting in a $125,000 reduction to their equity.

Additionally, investing the proceeds in Treasury bonds or CDs would only yield about 2 percent at current interest rates. Therefore, the Homeowners sought professional advice from Joe Honest, a financial planner and tax professional with a sterling reputation in their community. Mr. Honest proposed that they structure the transaction as an installment sale that would: allow the daughter to acquire a bank first mortgage at a desirable interest rate, receive a 4 percent interest rate on their investment, and avoid the entire $125,000 capital gain taxes.

Because the Homeowners needed only the $600,000 from the proceeds of the 3.85% 30 year· fixed-rate first mortgage to buy their modest retirement home, they decided to take a $600,000 second mortgage for the second half of the purchase price. The second mortgage was structured to pay only the 4 percent interest for 10 years; then the $600,000 principal would be amortized over the remaining 20 years with payment totaling $44,150 each year, about $40,000 of which would be taxable income either as interest or long term capital gain. The balance of their total $100,000 retirement income would consist of a $20,000 taxable pension and social security benefits of $40,000 annually. Because of the amount of their other income 85 percent, or $34,000 of the social security benefits would also be taxable. Therefore, the Homeowners adjusted gross income would be approximately $94,000 each year. Assuming a 2 percent inflation adjustment to the Homeowners' standard deduction and personal exemptions, it was assumed that in ten years they would be about $17,000 and $9,000 respectively bringing their taxable income down to about $68,000 placing them into the 15 percent marginal tax rate. Therefore, if the current zero capital gains tax rate for taxpayers in the 15 percent or lower tax bracket is extended into those future years, the Homeowners would pay no tax on the second $500,000 of capital gain on the sale of their home.

At this time, both political parties appear to support the extension of this tax break for middle-income taxpayers. This strategy should have the result of eliminating all capital gain taxes on the entire $1,000,000 long-term capital gain from the sale of the house. The $500,000 recognized in the year of sale would be excluded under § 121. The $500,000 recognized during the retirement years would be subject to tax at the 0 percent rate in IRC §1(h). Of course, the Homeowners have cash flow equal to their taxable income plus principle collections.

## CONCLUSION

Congress passed into law many features of our federal income tax without considering their interdependence with other features of the Internal Revenue Code. As a result, careful strategic planning can, at times, use one feature to minimize or eliminate the tax that another feature was supposed to extract from the taxpayers. In this paper, we have demonstrated how the installment sale features can be combined with three different areas of the Internal Revenue Code to minimize or completely eliminate the tax.

## REFERENCES

Internal Revenue Code of 1986 [Title 26, U. S. Code], §§ 1(h), 121, 453, and (repealed) 1034.