Home is Where the Tax Savings Are

One of the most common assets with which we deal in a divorce, and one which has some of the most favorable tax treatments available (and at the same time one for which the tax treatments are so often misunderstood by non-tax experts), is the marital home. While as a general statement there are many unique items within the Tax Code, the marital home indeed has a special place, blessed with certain tax benefits that are simply nowhere else to be found in the Tax Code.

The first thing to keep in mind is that reference here to the marital home, and references to special tax treatment, are limited to what would be considered one's principal residence. For probably 95+% of situations, that is very easily understood – it is where the family lives, and there is rarely any uncertainty as to what constitutes the principal, or primary, residence. If there are two or more residences, and if indeed more than one is used to a significant degree, that may create an uncertainty as to what constitutes one's principal residence. In such a case, you have a very complex matter and I suggest you stop reading at this point, and reach out to your friendly tax expert CPA to discuss this issue further. This article is merely raising that as a concern – we will not go further in that direction.

Once you have determined that you are dealing with the principal residence (and again remember that's pretty straight-forward for almost all of your cases), it is then a matter of appreciating an understanding of the special tax benefits inuring to the marital home (principal residence). These are:

- Tax-free profit – the first $250,000 of profit ($500,000 for a couple) realized on the sale of the house is completely tax-free. That applies not only to federal taxes, but also to NJ taxes. This is one of those truly special, great, freebies. By way of example, if a home cost $300,000 and is sold for $700,000, if it is owned by an unmarried person, $250,000 of the $400,000 profit is completely tax-free. The remaining $150,000 would be subject to capital gains taxation at the federal level and ordinary taxation by NJ (NJ doesn't have a special treatment for capital gains). However, if that house was owned jointly or, even if only owned by one of a married couple, selling it by the married couple would entitle them to shelter up to $500,000 of profit. In this example, the entirety of the $400,000 gain would escape taxation;

- Note that there is no longer (has not been for quite some time) any age or roll-over requirement. That is, at one time you had to be over age 50 when you sold to get certain tax benefits – that has not existed for many years. Similarly, at one time, to avoid taxation on the gain on the sale of one's home, you had to roll-over the sales proceeds into another house. That rule too no longer exists. Thus, you can avail yourself of this special tax treatment regardless of your age and regardless of what you do with the sales proceeds;

- ❖ You can take advantage of this tax rule every two years (at least in theory). That is, this is not a once in a lifetime matter – putting aside certain technical issues, and certain other concerns, the basic rule is that you can do this tax-free sale every two years. Whether or not you can possibly flip/turnover houses in which you lived every two years and accomplish this, is a separate economic issue;

- ❖ For a married couple, filing jointly, only one of them needs to have owned the house. It need not be in joint name. However, both needed to have lived in the house;

- ❖ Bad news (in a sense) – when a spouse buys the other out of the marital home, there is no step-up in basis. That is, the funds expended to buy out that other spouse's interest are a non-event from a tax point of view. As a simple illustration, as to the house that cost $300,000 that is now worth $700,000, if let's say the wife remains in the house, and buys out the husband's interest by paying him $350,000 for his half (assume for this exercise that there is no debt on the house), not only does the husband receive that $350,000 tax-free; but the wife gets zero tax benefit for her $350,000 expenditure. Her basis in the house remains $300,000. If she were to turn around the next day and sell it for $700,000, she would have a $400,000 gain. The matter of taxation is separate – we're talking here merely of the non-event represented by the buyout of a spouse's interest in a house (in virtually any asset).

An issue that we have posed to us regularly, deals with when there's a divorce, and one spouse remains in the marital home, while the other spouse moves out. Both remain as owners so that when the house is sold sometime down the road, the spouse no longer in the home gets his/her share (whatever that might be). The potential problem that arises here is that the spouse who has left the house (for this purpose we will use the rhyming phrase the "ousted spouse") no longer has that house as his/her primary/principal residence, and the tax law for favorable treatment on the sale of a principal residence requires that it had been your principal residence for at least two of the five years leading up to the sale of the house. This ousted spouse hadn't lived in the house for several years at the time it was sold. The good news is the "ousted spouse" rule provides that as long as, and to the extent that, one of the spouses remains living in that house, then both are treated as if living in the house for purposes of meeting the two years out of five (as well as ownership related issues) test. Thus, by way of example, the husband retains the house, and the wife moves out. Whether the wife, when moving out, rents an apartment or buys another house is irrelevant. Their agreement is that in seven years, the husband shall put the house up for sale, and at that time the ex-wife will receive her share of the proceeds (however they wish to define her share). When that happens seven years later, based on current tax law, up to the first $500,000 of profit – up to $250,000 for each of the ex-husband and ex-wife – is tax-free. It does not matter for this purpose that the ex-wife had not lived in that house for the last seven years.

A final comment – relating to mortgages, or debt. The existence or non-existence of debt attached to the house is irrelevant for these tax purposes. In this hypothetical, it does not matter whether this $700,000 house that has a cost basis of $300,000 has a $500,000 mortgage, a $100,000 mortgage, or no mortgage. The tax treatment is exactly the same – though of course the cash flow is worlds different. What that also means is that it's possible, in a situation where a house has been refinanced repeatedly, to wind up with a tax bill (think here in terms of a big gain) that exceeds the cash flow. That's because in that sense the cash flow has come out over the years via refinancing. That's a separate issue involving cash flow – it is not a tax issue.

As with so many situations involving taxes (and as with so many things involving anything that is of a technical nature), you would be well advised to seek the services of a CPA expert in taxes so as to handle the matter correctly. To give you one simple example in closing this article, assume it is contemplated that the marital home will be sold shortly after the divorce, but all of the proceeds are going to one of the spouses (let's say because there's some other asset that the other spouse is getting to balance the equation). Thus, logically, you're going to be removing that other spouse from the title – and the sale will eventually be in one name only. Be careful. If you went in that direction, upon the sale of the house, there would only be one owner for tax purposes – and thus only one $250,000 gain exclusion available. If this house had, as in this example, a $400,000 gain, there would be a $150,000 taxable gain, and assuming for simplicity a 25% combined federal and state tax, a tax cost of $37,500. I would suggest to you that is wasting $37,500. With a little tax planning, you could keep the house in joint name, still target all of the proceeds to go to just one spouse – and when the house is sold, each of the now ex-spouses can take $200,000 (half of the $400,000 gain) on their respective tax returns, with no adverse tax consequences to either, and an ultimate savings in this example of $37,500.