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TAX CONSEQUENCES OF SELLING A DECEDENT'S PERSONAL RESIDENCE

During the course of administering an individual's estate, Executor's often ask us "How should the estate report the sale of the decedent's personal residence? What are the tax consequences of a sale?" If there is a gain, these questions are not so hard to answer. However, whether or not a loss can be claimed has been challenged in the past, and there has been more guidance issued recently.

Sale of the Decedent's Personal Residence at a Gain
For estates of decedents dying after 2009, the $250,000 exclusion from gain ($500,000 if married and filing jointly) on sale of a decedent's personal residence will apply to sales made by the decedent's estate, a qualified revocable trust, or by any individual who inherited the property. This rule applies as long as the decedent met the ownership and holding period requirement prior to death.

Sale of the Decedent's Personal Residence at a Loss
Prior to the issuance of guidance in 1998, capital losses on the sale of a decedent's personal residence were allowed to be deducted by an estate under the premise of several judicial court decisions.

In several cases, such as *Estate of Pauline Miller, TC Memo 1967-4* and *H.V. Watkins, TC Memo 1973-167,* it was determined that the loss was deductible as a capital loss subject to the normal capital loss limitation rules as long as the residence is no longer used as a personal residence by a beneficiary after the decedent's death. Part of the rational was that, if the residence is not held for business or personal use, then the only choice left is for investment use.

In 1998, in response to several Form 1041 that were disallowed losses from the sale of a decedent's personal residences, the Office of Chief Counsel issued Service Center Advice 1998-012. First, the advice provided that an estate generally **may not deduct a loss** incurred on the sale of a decedent's personal residence, **unless the residence has first been converted to an income-producing asset** according to IRC sections 641(b) and 164(c). Second, the loss was deductible by the estate only in the instance where, under state law, the real property did not vest in the decedent's devisees upon death. In general terms this would mean that if a decedent's Will specifically devised real property to an heir, that property passed at the moment of death to that heir and thus any loss on the sale would be reportable by the person treated as the owner of the property under state law rather than by the estate. If however, the real property became part of the residuary estate and thus could be used to satisfy the decedent's debts and obligations, then a loss incurred from a sale to effectuate the administration of the estate, would be reportable by the estate on Form 1041. The advice went further to describe a situation where property was left by will to a named person or persons and was sold to satisfy the estate's obligations. Then, only the portion of the loss associated with the sales proceeds used to satisfy the estate's obligations would be reported on Form 1041 and the balance would be reported by the devisees on their personal returns.

The more recent guidance is detailed *in IRS Publication 559, Survivors, Executors and Administors (2010)*. It states that:

> *If the estate is the legal owner of a decedent's residence and the personal representative sells it in the course of administration, the tax treatment of gain or loss depends on how the estate holds or uses the former residence. For example, if, as the personal representative, you intend to realize the value of the house through sale, the residence is a capital asset held for investment and gain or loss is capital gain or loss (which may be deductible). This is the case even though it was the decedent's personal residence and even if you did not rent it out. If however, the house is not held for business or investment use (for example, you intend to permit a beneficiary to live in the residence rent-free and then distribute it to the beneficiary to live in), and you later decide to sell the residence without first converting it to business or investment use, any gain is capital gain, but a loss is not deductible.*

The guidance in the IRS Publication suggests that, as long as the estate is the legal owner of the decedent's residence, and the estate has the intent to sell the home (without converting it to income-producing property), then a loss upon sale would be deductible as a capital loss on the estate's Form 1041.

What's the Basis of the Home?

If a Federal estate tax return was filed, the basis of the home in the hands of the estate or devisees would be its fair market value as reported on the Form 706. If there was no requirement to file a Federal estate tax return, and an Ohio Estate Tax return was required, then the basis would be what was used for Ohio Estate Tax purposes. This, generally, will be the fair market value of the home on the date of death, or the appraised value as determined under the particular probate court requirements, and filed as part of the inventory of the decedent's estate.

Conclusion

With the declining real estate prices over the last few years, many estates have sold the decedent's former residence at a loss. Whether the estate can take a deductible capital loss is subject to debate. Prior to IRS guidance issued in 1998, judicial guidance indicated that an estate could claim a capital loss on the sale of the decedent's personal residence without a requirement that the property be converted to an income-producing purpose. However, in response to a number of returns that were filed claiming losses on the sale of the decedent's residence, the IRS issued Service Center Advice 1998-012. This guidance generally concluded that an estate could not deduct the loss on the sale of a decedent's personal residence unless the residence had first been converted to an income-producing asset and only by an estate that was the legal owner of the property. Now, guidance indicates that, as long as the estate is the legal owner and a beneficiary does not use the residence as a personal residence, a loss will generally be allowed as a capital loss on the estate's Form 1041, regardless of whether the property has been converted to income-producing property.