Understanding Capital Gains in Real Estate Sept 2015

In real estate, a capital gain is the difference between the basis (usually the amount paid for the property, plus improvements and transaction costs) and the current sale price.

Basis is the starting point for determining gain or loss. Capital improvements and transaction costs increase basis; depreciation (on investment or income property) reduces it. The lower the basis, the higher the gain, and conversely the higher the basis, the smaller the tax implications. For capital gains tax purposes, a high basis is best.

Long term capital gains are value increases on assets owned for more than a year, varying tax rates apply, based on the owners tax bracket. Gains on property owned for less than a year are taxed as ordinary income.

Basis step-up for Heirs

The basis step-up is an important concept for transfer of property to heirs. The estate is subject to tax based on fair market value of the assets at the time of death, not the deceased’s basis. But heirs receive the estate assets with a stepped up basis of fair market value at the date of the decedents’ death. This means if an heir sells an asset received from the estate before the asset further appreciates in value, there is no capital gain tax due on the sale.

Basics on Capital Gain

A capital gain of up to $250,000, or $500,000 for married couples filing jointly, is exempt from tax if the property has been owned and used by the taxpayer as a primary residence for at least two years out of the five years prior to sale. The stepped up basis rule applies to real property included in the descendant’s gross estate. In community property states, surviving spouses benefit from a stepped up basis for both the inherited and their own shares of community property.

* The exemption does not require a minimum age or rollover to a higher valued property. It can be claimed repeatedly as long as residency requirements are met.
* A widowed homeowner can claim the full $5000 exemption if the sale occurs within two years of the death of the spouse and the surviving spouse has not remarried.
* Military and Foreign Service personnel on qualified active duty assignments are allowed to suspend the five-year test period to up to 10 years.
* If the homeowner must sell due to illness or disability, (their own or that of a family member for whose care they are responsible), job relocation, or specified unforeseen circumstances, a prorated portion of the gain is excluded. For example if a homeowner lived in a house as a primary residence for one year before becoming disabled and forced to sell a home in order to relocate to a care facility, the exemption would be reduced by ½, $125,000 of capital gain would be exempt. A physician must certify the need for medical care.
* Capital losses on the sale of a personal home are not deductible.
* A personal residence is not depreciable for tax purposes.