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February 2005 - I Sold Property I Inherited, How is Income Tax Determined?

My last article discussed the impact a death in the family can have on your income tax, and a simple look at how income tax differs from estate tax. This week we will build on that discussion to go into greater detail about how income tax is determined when inherited property is later sold.

When any property is sold, whether it is real estate, mutual funds, or something else, computing the income tax on the sale starts by determining the basis of the property. In many cases, the basis is simply the price that was paid for the property when it was purchased. You should add purchasing costs, including recording fees and other items listed on your purchase closing statement that were not deductible at the time of purchase. For example, loan origination fees and property taxes usually can be deducted on the tax return filed for the year the purchase occurred. Since they were deductible then, they are not added to basis. This usually still leaves many purchase costs that can be added to basis and thus reduce the income tax that is paid when the property is sold.

You can also add to basis the cost of capital improvements made during the time you owned the property. These are major additions that add to the value of the property, for instance, adding a new room. Routine maintenance would not be considered a capital improvement, and cannot be added to basis.

If depreciation was allowable on the property it is deducted from basis. That is all of the accumulated depreciation for the entire period it was allowable.

Once basis is determined, it is subtracted from the net selling price to determine taxable gain. Net selling price refers to the amount received after selling costs such as commissions and fixing-up expense done in the 90 day period immediately before the sale to prepare it for sale.

The unique aspect of selling inherited property is that you are treated as purchasing it on the death date of the person you inherited it from, and your basis is the fair market value on that date. **This can be an enormous benefit, since you will not have to pay income tax on any of the gain in the property value during the time the deceased owned it.** You do have the burden of providing written evidence of what that fair market value was on the death date.

In the language of income tax, this is called a “step-up in basis”. **This step-up also applies to property that was jointly owned by the spouse of the deceased, and inherited by that spouse on the death date.** Let me give a couple examples that will help illustrate this.

Suppose you and your deceased spouse jointly bought shares in a mutual fund for $10,000 in 1990, your spouse died on July 1, 2003, and on that day those shares were worth $40,000. Your basis in the shares is determined as follows:

Half of the basis is attributed to you, and half to your deceased spouse. Your half is $10,000 divided by 2, or $5,000. Your deceased spouse's half is $40,000 (the fair market value on the death date) divided by 2, or $20,000. You inherit this $20,000 basis and add it to the $5,000 basis for the half of the property you already owned, making your total basis $25,000. If you then sell these shares on December 1, 2004 for $45,000, your taxable gain would be $45,000 less your basis of $25,000, or $20,000. This would be a $15,000 smaller taxable gain than if you had used the original basis of $10,000 before your spouse's death.

In the second example, suppose you jointly owned a home with your spouse that had been your principal residence for many years at the time of your spouse's death. You bought it together early in your marriage for $30,000. At the time of death it was worth $300,000. A few years later, you decide to move in to something smaller and sell it for $350,000. Your question of course is, do I owe income tax on the gain on this residence, and if so, how much?

Again, it is important to get the basis right. If you simply used the original purchase price of $30,000 as your basis, then your gain would be $320,000 (that is, $350,000 minus $30,000). As a single person, the first $250,000 of gain on the sale of your principal residence is tax free, which would leave you paying tax on a gain of $70,000. You would qualify for long term capital gain treatment, but would likely pay 15% federal tax on that, or $10,500. State tax would probably run $4,900 to $6,500 more.

Hopefully, you got an appraisal in the weeks following your spouse's death that provides written support for the $300,000 value at the time of death. Using this appraisal, your basis is determined by taking the basis on the half of the property you owned from the original purchase date plus your stepped up basis on the half of the property you inherited from your spouse at death. Half of the original purchase price is $15,000 ($30,000 divided by 2) and the inherited half has a basis of $150,000 ($300,000 divided by 2). This gives you a total basis of $165,000 in the residence. When you sell it for $350,000, your gain is $185,000. Since this is below the $250,000 tax free amount, you would have no taxable gain and no tax due!

The information in this article is intended to inform you of some of the financial opportunities provided in the tax laws or elsewhere. These laws are very complex and thus this article is not intended to give you specific advice for your personal situation. If you need such advice, please contact a qualified professional.