

# Explaining the Basis of Inherited Real Estate

*What is cost basis? Stepped-up basis? How does the home sale tax exclusion work?*

Provided by Hatcher Financial, P.C.

**At some point in our lives, we may inherit a home or another form of real property.** In such instances, we need to understand some of the jargon involving inherited real estate. What does “cost basis” mean? What is a “step-up?” What is the home sale tax exclusion, and what kind of tax break does it offer?

Very few parents discuss these matters with their children before they pass away. Some prior knowledge of these terms may make things less confusing at a highly stressful time.

**Cost basis is fairly easy to explain.** It is the original purchase price of real estate plus certain expenses and fees incurred by the buyer, many of them detailed at closing. The purchase price is always the starting point for determining the cost basis; that is true whether the purchase is financed or all-cash. Title insurance costs, settlement fees, and property taxes owed by the seller that the buyer ends up paying can all become part of the cost basis.<sup>1</sup>

At the buyer’s death, the cost basis of the property is “stepped up” to its current fair market value. This step-up can cut into the profits of inheritors should they elect to sell. On the other hand, it can also reduce any income tax liability stemming from the transaction.<sup>2</sup>

**Here is an illustration of stepped-up basis.** Twenty years ago, Jane Smyth bought a home for \$255,000. At purchase, the cost basis of the property was \$260,000. Jane dies and her daughter Blair inherits the home. Its present fair market value is \$459,000. That is Blair’s stepped-up basis. So if Blair sells the home and gets \$470,000 for it, her complete taxable profit on the sale will be \$11,000, not \$210,000. If she sells the home for less than \$459,000, she will take a loss; the loss will not be tax-deductible, as you cannot deduct a loss resulting from the sale of a personal residence.<sup>1</sup>

The step-up can reflect more than just simple property appreciation through the years. In fact, many factors can adjust it over time, including negative ones. Basis can be adjusted upward by the costs of home improvements and home additions (and even related tax credits received by the homeowner), rebuilding costs following a disaster, legal fees linked to property ownership, and expenses of linking utility lines to a home. Basis can be adjusted downward by property and casualty insurance payouts, allowable depreciation that comes from renting out part of a home or using part of a residence as a place of business, and any other developments that amount to a return of cost for the property owner.<sup>1</sup>

The Internal Revenue Code states that a step-up applies for real property “acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent.” In plain English, that

means the new owner of the property is eligible for the step-up whether the deceased property owner had a will or not.<sup>2</sup>

In a community property state, receipt of the step-up becomes a bit more complicated. If a married couple buys real estate in Arizona, California, Idaho, Louisiana, New Mexico, Nevada, Texas, Washington, or Wisconsin, each spouse is automatically considered to have a 50% ownership interest in said real property. (Alaska offers spouses the option of a community property agreement.) If a child or other party inherits that 50% ownership interest, that inheritor is usually entitled to a step-up. If at least half of the real estate in question is included in the decedent's gross estate, the surviving spouse is also eligible for a step-up on his or her 50% ownership interest. Alternately, the person inheriting the ownership interest may choose to value the property six months after the date of the previous owner's death (or the date of disposition of the property, if disposition occurred first).<sup>2,3</sup>

In recent years, there has been talk in Washington of curtailing the step-up. So far, such notions have not advanced toward legislation.<sup>4</sup>

**What if a parent gifts real property to a child?** The parent's tax basis becomes the child's tax basis. If the parent has owned that property for decades and the child cannot take advantage of the federal home sale tax exclusion, the capital gains tax could be enormous if the child sells the property.<sup>2</sup>

**Who qualifies for the home sale tax exclusion?** If individuals or married couples want to sell an inherited home, they can qualify for this big federal tax break once they have used that home as their primary residence for two years out of the five years preceding the sale. Upon qualifying, a single taxpayer may exclude as much as \$250,000 of gain from the sale, with \$500,000 being the limit for married homeowners filing jointly. If the home's cost basis receives a step-up, the gain from the sale may be small, but this is still a nice tax perk to have.<sup>5</sup>

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#### **Citations.**

1 - [nolo.com/legal-encyclopedia/determining-your-homes-tax-basis.html](http://nolo.com/legal-encyclopedia/determining-your-homes-tax-basis.html) [3/30/16]

2 - [realtymag.com/consumeradvice/sellersadvice1/item/34913-20150513-inherited-property-understanding-the-stepped-up-basis](http://realtymag.com/consumeradvice/sellersadvice1/item/34913-20150513-inherited-property-understanding-the-stepped-up-basis) [5/13/15]

3 - [irs.gov/irm/part25/irm\\_25-018-001.html](http://irs.gov/irm/part25/irm_25-018-001.html)

4 - [blogs.wsj.com/totalreturn/2015/01/20/the-value-of-the-step-up-on-inherited-assets/](http://blogs.wsj.com/totalreturn/2015/01/20/the-value-of-the-step-up-on-inherited-assets/) [1/20/15]

5 - [nolo.com/legal-encyclopedia/if-you-inherit-home-do-you-qualify-the-home-sale-tax-exclusion.html](http://nolo.com/legal-encyclopedia/if-you-inherit-home-do-you-qualify-the-home-sale-tax-exclusion.html) [3/31/16]