# A Primer on the Tax on Capital Gains

## By Harry S. Margolis

We find that many of the questions we receive in the office, and through our firm website and on Harry's AskHarry.info website involve capital gain and the tax on capital gain. So, here's a primer intended to answer most, if not all, questions about capital gains.

1. **What is capital gain?**

Capital gain is the difference between the basis in property, whether real estate, stock, antiques or artwork, and the net proceeds of its sale.

2. **What is basis?**

Basis starts as the purchase price of any property.

3. **How is basis adjusted?**

However, basis may be adjusted up or down. For real estate, the basis may be increased by the cost of improvements to property. For instance, if you buy a house for $750,000 and then spend $250,000 updating the kitchen and bathrooms, the new basis will be $1 million.

The main way basis may be reduced is for commercial property. To the extent the owner depreciates property (takes an income tax deduction due to the supposed reduction in value to property based on wear and tear) the basis is also reduced.

4. **How does the step-up in basis work?**

The biggest adjustment to basis for all forms of property occurs when the owner dies. At that point, the basis is adjusted to the value on the date of death. Since values almost always increase over time, this is known as a "step-up" in basis. It serves both to relieve the heirs from having to pay a tax when they sell the property and to ease bookkeeping since it can sometimes be difficult to determine the purchase price of property bought many decades in the past.

So, for example, if the house that had a basis of $1 million had a fair market value of $1.5 million on the owner's death, that becomes the new basis. If the heirs sell it immediately, then they incur no capital gains. If, instead, they were to wait several years and sell it for $2 million, then they would incur a capital gain of $500,000.

One question that often arises is how fair market value determined for purposes of establishing the step-up in basis. If the house is being sold, the sales price establishes the fair market value and the new basis. That makes sense, since there's no better determinant of fair market value than the market itself. However, if the property is not being sold immediately, then the best determinant of fair market value is a formal appraisal. Some taxpayers attempt to save money by using the real estate tax assessment, Zillow, or a valuation by a real estate broker, but these will not withstand muster if challenged by the IRS. Of course, if you do get audited, you then can obtain a formal appraisal.

The relief from the tax on capital gains was meant as something of a trade off since in the past inherited property was often subject to an estate tax. The idea was to prevent double taxation –

both the estate tax and the tax on capital gains. But now that the federal estate tax threshold has been increased to $13.6 million (for those dying after 2024), very few estates are subject to the estate tax, although they all receive the benefit of the step-up in basis. Many more are subject to the Massachusetts estate tax whose threshold was recently raised from $1 million to $2 million.

5. **What about carry-over basis?**

If you give someone property, again whether real estate, stock, or tangible property such as antiques or artwork, the recipient will receive it with the same basis as the prior owner. This is known as "carry-over" basis. It is one reason that it's often better to inherit property than to receive it as a gift.

This often comes into play with respect to MassHealth planning. Many clients come to us saying that they want to give their house to their children or, if it's the children coming in, that their parents should transfer their house to them to protect it from MassHealth estate recovery. This makes us nervous because the house is no longer as secure. The children may run into financial difficulty, get divorced, pass away, or simply decide that it's time for their parents to move out of the house. But what usually slows down the transfer train is our explanation of the capital gains consequence if the house is gifted to the children. They'll receive a carry-over basis rather than a step-up, resulting in much higher taxes when the house is sold. While these taxes are certain, the need for long-term care and eventual MassHealth estate recovery is uncertain.

Fortunately, there are ways to protect the home and still receive a step-up in basis. (More on these techniques below.)

6. **How much is the tax?**

Up until recently, the federal capital gains tax rate was 20%. But Congress decided to graduate it based on the taxpayer's overall income, so now the rate can vary from 0% up to 20%. Here are the single and married rates and thresholds for the 2024 tax year:

| **Filing Status** | **0% Rate** | **15% Rate** | **20% Rate** |
|---|---|---|---|
| **Single** | Up to $47,025 | $47,026-$518,900 | Over $518,900 |
| **Married filing jointly** | Up to $94,050 | $94,051-$583,730 | Over $583,730 |

Massachusetts taxes capital gain at the same 5% rate as other income. So most taxpayers in Massachusetts will pay a combined rate of 20%, but if they are relatively low income they may pay only the Massachusetts tax on some or all of their income. And if they're high income or sell property for a very high gain, they may pay a total of 25% on some or all of their gain.

In addition, on the federal level short-term capital gain, that is gain on anything owned for less than a year before it's sold, is taxed at the same rates as ordinary income. In it's recent tax relief bill, Massachusetts reduced its short-term capital gain tax rate from 12% to 8.5%. We were opposed to this change because the higher rate discourages speculation and helps stabilize markets, but those who do trade and wanted the lower rate convinced Governor Healey and the legislature of the wisdom of lowering the rate on short-term capital gain.



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### 7. How does the $250,000 exclusion on the sale of the principal residence work?

As you probably know, pursuant to Section 121 of the Internal Revenue Code, you may exclude up to $250,000 of gain on the sale of your home. Co-owners, whether or not they are married, can each exclude $250,000 of gain, for a total of $500,000 (or even more if there are more than two owners and they all reside in the property). To qualify, the taxpayers must have owned and lived in the property for at least two out of the five years prior to its sale.

In our example above of the house with a $1 million basis that sells for $1.5 million, a single owner would still have to pay a tax on $250,000 of the gain. A married couple would pay no tax.

The main difference between married and unmarried owners is that both spouses don't need to have owned the property to qualify for the full $500,000 exclusion as long as they have both lived there for at least two out of the prior five years. In addition, if one spouse has died, the surviving spouse can still exclude the full $500,000 if they sell the home within two years after the deceased spouse's death. (You may wonder why this benefit is necessary since the house received a step-up in basis after the first spouse died. There are two possible answers. First, the house probably only received a one-half step-up since the deceased spouse presumably was a co-owner. As a result, there could still be more than $250,000 of gain remaining. Second, the full $500,000 may be necessary if the deceased spouse did not have an ownership interest in the property, in which case it would have received no step-up upon their death.)

### 8. Can't you carry over your basis to a new property?

Many people believe that they will not incur a tax on capital gain if they use the proceeds of the sale of property to purchase new real estate. Instead, the basis in the new property would be their basis in the property that was sold rather than the purchase price of the new property. The reason many people have this misconception is that that was once the law. But it was repealed in 1997. That said, if you carried over your basis prior to 1997 and now sell your property, you'll be stuck with the lower basis. (You can get a carry-over basis with rental property, through a 1031 exchange, but that's a whole other topic.)

### 9. What about trusts, a life estate or joint ownership?

Can you have your cake and eat it too? In other words, can you have some of the benefits of transferring your house during life, such as MassHealth protection and avoiding probate, and still provide a step-up in basis for your heirs. The answer is yes through a trust, a life estate, or joint ownership, though each has its benefits and drawbacks.

#### a. Joint ownership

If you add a child's name to your house as joint owner, upon your death the house will pass directly to your child. It will avoid probate and MassHealth estate recovery. It also should receive a complete step-up in basis. This is because you no doubt put your child's name on the deed for estate planning purposes, not really planning on giving them a one-half interest in the house. However, the child would have a true ownership interest in the house and it would be at risk if the child ran into financial difficulties, went through a divorce, or decided to sell their interest. If you and your child were to sell the house, you could only exclude up to $250,000 of the gain attributable to your half the proceeds (unless your child had lived in the house for at



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least two out of the five prior years.) If your child died before you, the house would revert to your ownership.

### b. Life estates

A life estate solves some of the risks of joint ownership. It is a form of co-ownership where you control of the property during your life and your child or children gains control and full ownership upon your death. It's at less risk if something unexpected happens to your child and you retain the right to live there and receive rental income during your life. If the house is sold during your life, the proceeds are distributed based on IRS tables that take into account your age and current interest rates. Again, you can only exclude up to $250,000 of the gain attributable to your share of the proceeds. Your child or children would not be able to exclude the gain attributable to their share. But if they waited until your death to sell the property, they would receive a complete step-up in basis.

### c. Trusts

Trusts are a bit more complicated. Property in revocable trusts is treated as belonging to the grantor, so qualify on sale for the full $250,000 or $500,000 exclusion. At the death of the grantor, the property in trust receives a full step-up in basis. But revocable trusts provide no MassHealth protection, just probate avoidance.

Irrevocable trusts can provide MassHealth protection. In fact, they provide more protection than life estates or joint ownership because they also protect the proceeds of the sale of a home during the owner's life. However, whether they receive a step-up in basis upon the grantor's death or allow for the exclusion of $250,000 of gain on the sale of property depends on how the trust is written. That said, virtually all irrevocable trusts provide for the step-up in basis by being written in such a way that the trust property remains in the grantor's taxable estate. (Remember, very few estates in fact incur an estate tax.) It's more difficult to draft a trust to qualify for the $250,000 capital gains tax exclusion, especially if the purpose of the trust is for MassHealth planning. There's a fine line to draw that preserves the grantor's ownership for tax purposes while removing their ownership for MassHealth purposes. But it's a fine line that MassHealth planning trusts seek to draw.

Let us know if you have further questions related to the tax on capital gains that this primer does not answer.



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