Reduce your capital gains tax even further

How to use property improvements to recalculate cost basis

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Q: I want to sell my house and downsize to a condo. My parents, who are both deceased, transferred their house to me back in 2001, when they were alive.

They bought the home in 1966 for $38,750. Today it should sell for about $650,000. I now know that this was a mistake because of the huge capital gains tax I will owe on the property. I am single, so I have only a $250,000 exemption, which means I'll have a big tax bill to pay.

I'm trying to make the best of a bad situation. In calculating the cost basis for the property, how does one distinguish between a home improvement and a repair?

Can an improvement such as a fence be counted more than one time? We've put in three fences over the 40 years since the house has been built.

Also, I want to know if it's OK to estimate the cost of some of these improvements, since some of them took place 35 to 40 years ago and there is no formal documentation for them. Also, my parents took out a mortgage when they first purchased the house; can this be considered an improvement?

Finally, I just had both the outside and inside of the house professionally painted; can this be counted as an improvement? (I think that I already know the answer to this one). Thanks! I hope that you can answer my questions!

A: Yes, transferring ownership to you via a quitclaim deed was a mistake. I'm glad you recognize that now, although it would have been better to consult an attorney in the beginning.

And while you'll have a big tax bill to pay, you have to think about the silver lining -- at least the property has risen dramatically in value and you'll wind up with a big chunk of that cash.

When it comes to calculating the cost basis, you can include anything that was a structural fix, including adding or replacing fences, replacing the roof, adding rooms to the property, gut-renovation and home improvement such as a new bathroom. But you cannot include decorating, nor can you subtract the cost of the original mortgage.

You should take a look at a booklet published by the Internal Revenue Service: Publication 523, "Selling Your Home." It has some good examples and guidelines you need to follow to compute the basis for the home.

The booklet has a laundry list of items that are considered improvements to a home. Among those items are fences. In looking at the items you may also recognize other improvements that you or your parents added to the home, including landscaping, new windows, insulation and new kitchen appliances.

But if you installed various fences in the many years you or your parents lived at the home, you won't be able to add the cost of installing multiple fences to your cost basis. According to Publication 523, you will be able to add only the cost of the most recently installed fence to the cost basis of the home.

Since there is no formal documentation, you'll have to estimate based on your knowledge of what was done to the property. Please talk to a good accountant who can assist you with this. If you have no written paperwork to support your expenses, you may have trouble supporting your claim if you were to get audited by the IRS.

Before you add it all up, don't forget to include the costs for purchase and sale, including the commission, advertising or marketing costs, and any other fees you paid.

Q: I am in a very bad situation. I bought my house 18 months ago for $358,000. Now, similar homes in the area are selling only for $345,000.

I tried to sell the property but I'd have to come up with almost $30,000 to close, and that's money I just don't have. I can't afford the payments anymore, and yet, if I don't sell the property or figure out a way to come up with the payments, I'm going to be forced not to pay them.

I want to try to convince my lender to do a short sale. Can I do that before being late on my payments? Help!

A: You're in an incredibly difficult situation. From where I sit, you have only two options at the moment, neither of them particularly pleasant: You can either get a part-time second job to help increase your income (so that your payments are affordable), or you can sell your home and find a way to get $30,000 in order to pay off the lender.

You can ask the lender to do a short sale. If you don't have any other assets, the lender may agree to it, but that will bring up another unpleasant subject: income taxes.

What you may not realize is that the IRS treats a short sale as income to the borrower. So if you owe $350,000 on your loan, but sell your home for $330,000, you owe $20,000 to the lender. If the lender accepts the lesser amount (known as a short sale), the IRS will see the missing $20,000 as "phantom" income. You'll then owe income taxes on the phantom income.

I know this seems unfair, so I hope you can figure a way out of this problem. Please talk to a good real estate attorney about how short sales work and whether this is truly a good option for you at this time.

To get even more valuable advice from Ilyce, visit her ***Personal Finance and Real Estate Center****.*

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