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By Michael Giangrande, J.D., LL.  .

# Tax treatment of an inherited house — it's not simple

**ESTATES: Taxes are based on how the residence is used by the heir, not by the decedent.**

**By Richard B. Malamud, J.D., LL.M., CPA**
*Guest Contributor*

The tax consequences when someone inherits a residence depend on how it is used by the heir. As one court said, "To what use was the property put after it was acquired by inheritance?"[1] Any prior tax issues, such as passive loss carryovers or accumulated depreciation, disappear. One unique aspect of inherited property is that even if sold within one year or less, it is treated as long-term capital gain property.[2]

There are four possible tax uses:

1. Quick sale;
2. Move into as a principal residence (or as a second home);
3. Temporarily rent it while listing it for sale; or
4. Convert it into a rental property.

### Quick sale

The decision upon inheriting a house to sell it results in either a long-term capital gain or loss because the home is treated as an investment as are other inherited assets. The sale of property soon after inherited, whether it is a house or even a yacht, prevents it from being considered personal use property.[3] That lack of conversion is demonstrated by the immediate (or as soon as practical) listing for sale.

Although counterintuitive, in many cases the resulting sale will produce a tax loss, as an inherited residence receives a fair market value basis at the date of the decedent's death, and the commissions and other expenses will often generate a deductible loss when sold soon after death.[4]

The tax basis will be the amount reported on the Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, if an estate tax return was required to be filed, and that basis will be reported to the taxpayer on Schedule A, Form 706.[5] Otherwise, the tax basis will be the fair market value at date of death.

**EXAMPLE 9-4:** Mom dies and her home is appraised and reported on Form 706 as $750,000. Son inherits it and lists it immediately, and it is sold six months later for $760,000. Commissions and selling expenses were $42,000. The long-term loss is $32,000. Note that the house actually went up in value ($760,000 sales price – $750,000 basis – $42,000 expenses).

This investment approach to inherited assets also applies if the house was jointly owned by a husband and wife if it is sold by the survivor very soon after the death.[6] If the property was community property, both the decedent's half and the survivor's half receive a fair market value stepped-up basis at death.[7] The character of the property would probably depend on how the surviving spouse uses the property thereafter, and how the other beneficiary uses it.

It's probably better not to wait too long if the house will be sold at a loss. In one case, the taxpayer kept the house for six years after her mother's death, for appreciation purposes. The house was never rented. Occasionally, her child stayed in the house. The court disallowed deductions because it treated the house as a personal residence and not an investment.[8] As a personal residence, loss on the sale is not deductible.

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### House used as a residence by the heir

If the heir moves into the house, it will either be a principal residence or a second residence. The normal tax rules for a taxpayer's residence will apply. Except for interest and taxes, no other expenses paid to maintain the property are deductible.[9]

Where a son moved into his mother's home after her death and two years later sold the house at a loss after a very short rental, the loss was disallowed and deemed a personal loss. The court said that moving into the house had the effect of "fixing the character of the property in their hands as residential."[10]

If the property is inherited by the deceased spouse, the time the decedent owned and lived in the house is counted toward the two-year holding period required for the IRC §121 exclusion if sold within two years of death.[11] This rule applies if the taxpayer has not remarried.

### Short-term versus long-term rental

There are two rental possibilities:

- Short-term, while trying to sell the property (but how long is "short-term" is hard to say); and
- Long-term, when the property is converted to a rental property.

In both cases, a loss should be allowed upon sale because the property will be considered investment or rental property.[12]

When the property is rented for a short period to reduce the cost of carrying the property until its sale, it is not treated as rental property. It will be treated as investment property (rather than rental property) if it appears that the intent is to sell the property.

As investment property, expenses are allowed only as miscellaneous itemized deductions. Interest and property taxes would be deductible under the normal itemized deduction rules, and the other expenses should be miscellaneous itemized deductions subject to the 2% floor for individuals and also for fiduciaries, unless the costs would not have been incurred if the property were not held in an estate or trust.[13] As investment property, the sale will result in a long-term gain or loss.

The IRS might try to treat the property that isn't sold in a timely manner, but is occasionally rented out to pay the expenses, as personal property and not investment or rental property. The IRS might argue that, under IRC §183, deductions are limited to the rental income where the property is vacant for a long period of time and is then rented on a short-term basis at a loss.[14]

Waiting too long to make a decision on what to do makes it difficult to determine whether the primary purpose was to hold it as a personal residence or as an investment. If the IRS is successful in treating the property as a personal residence upon the sale, no loss would be allowed — but gain would be taxable as long-term capital gain.

If there are periods of rental and nonrental and the sale occurs a few years after the death, the regulations provide a nine-factor test to determine if an activity is engaged in for profit.[15] A case, however, listed the following abbreviated version:

1. Were there offers to sell or rent at fair market value?
2. Did the taxpayers abandon the house (possibly relevant if the taxpayer lived in the house prior to the death)?
3. What was the reason for the rental (was their only reason for renting to make a profit)?[16]

### Property converted to rental

When the facts show that the house was rented out soon after it was inherited with the sole intent for it to be rental property, it will be treated as rental property. Net rental income (or loss) is reported on Schedule E. Normal tax issues for rental property apply as if the heir purchased the property, such as:

- Allocation of the basis to land, building, and personal property and depreciation thereof;
- Determining if fixing-up costs are repairs or capital expenditures;
- Passive activity issues;
- At-risk issues; and
- IRC §1231 gain or loss on sale.

### Property held by the estate

If the estate or administrative trust holds the house during its administration, some administrative expenses relating to the ongoing cost of the house and any loss if it is sold may be allowable on either the estate tax return or the income tax return of the fiduciary,[17] but the expense or loss can only be taken on one of the returns. Priority is given to the estate tax return, unless an irrevocable election is made to take the loss on the trust return rather than on the estate tax return.[18]

The deduction or loss is only allowed on the estate tax return if the sale is necessary to pay the estate's debts, administrative expenses, or taxes, or is required to preserve the estate or to make distributions, which is not often the case.[19] As one court stated, "[W]e also can discern no reason why the estate would be responsible for selling (the home) and maintaining it."[20]

**About the Author**

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[1] ***Campbell v. Comm.*** (1945) 5 TC 272

[2] IRC §1223(9)

[3] ***Marx v. Comm.*** (1945) 5 TC 173

[4] IRC §1014(a)(1)

[5] IRC §1014(f)

[6] ***Watkins v. Comm.***, TCM 1973-167

[7] IRC §1014(b)(6); Treas. Regs. §1.1014-2(a)(5)

[8] ***Ray v. Comm.***, TCM 1989-628

[9] Treas. Regs. §1.212-1(h)

[10] ***Horrmann v. Comm.*** (1951) 17 TC 903

[11] IRC §121(b)(2), (d)(4)

[12] ***Campbell v. Comm.*** (1945) 5 TC 272

[13] IRC §67(e)(1)

[14] See, for example, IRC §183(b). See also Rev. Rul. 74-28

[15] See Treas. Regs. §183-2(b) and ***Sherlock v. Comm.*** (1972) 31 TCM 383, in which expenses were deductible during unsuccessful rental period prior to sale

[16] ***Bolaris v. Comm.*** (1985) 776 F2d 1428

[17] IRC §2053 or §2054

[18] IRC §642(g)

[19] Treas. Regs. §20.2053-3(d)

[20] ***Estate of Millikin v. Comm.*** (1997) 106 F3d 1263

## News Briefs

**Tax Court allows EIC where it probably shouldn't have** — The Tax Court allowed a taxpayer to take the Earned Income Credit (EIC) even though they revised his filing status from head of household to married filing separately.[1] Under IRC §32(d), if an individual is married, the EIC is allowed only if a joint return is filed for the tax year. The IRS has announced that it will not acquiesce to this decision.[2] The Tax Court has previously held that taxpayers filing as married filing separately don't qualify for the credit.[3]

[1] ***Tsehay v. Comm.***, 2016-200

[2] AOD 2017-05 (July 6, 2017)

[3] See ***Harkless v. Comm.***, TCM 1999-58

**Return filed without consent was invalid** — A taxpayer filed a joint return for himself and his soon-to-be ex-wife, based on an agreement via text message to file a joint return and split the refund.[4] The taxpayer received the refund but did not share it with his wife as agreed. However, married filing joint status is not allowed unless both spouses intend to make a joint return. In this case, the wife, having not heard back from her husband regarding the filing, attempted to file a married filing separate return. Because she hadn't signed a filing authorization for the joint return, there was technically no agreement between the taxpayers to file a joint return and the husband's proper status was MFS.

[4] ***Edwards v. Comm.***, TCS 2017-52

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