CAPITAL GAINS EXPLAINED

Every homeowner wants to make a significant profit on their home when they sell it. But beware, some of your profit may go to the capital gains tax. If your home has substantially increased in value, you could be liable for a substantial sum when you pay your annual income tax. Fortunately, there are ways to avoid or reduce the capital gains tax on a home sale to keep as much profit in your pocket as possible. Here’s everything you need to know.

WHAT IS CAPITAL GAINS TAX?

The capital gains tax in California is applied to the profit you make from selling certain assets, like stocks, bonds, and real estate. The rate could vary because it is taxed as regular income. To calculate your capital gains taxes in California, you'll need to know your marginal tax bracket.

Capital Gain = Sale Price of Asset - (Adjusted Basis + Selling Expenses)

For example, let's say you bought a house in Los Angeles for $500,000 and sold it later for $700,000. Your capital gain would be $200,000 ($700,000 - $500,000). If you had selling expenses of $20,000 (e.g., real estate commissions), your capital gain would be reduced to $180,000. And if your adjusted basis was $250,000 (e.g., purchase price + capital improvements), your capital gain would be further reduced to $130,000.

AVOIDING A CAPITAL GAINS TAX ON YOUR PRIMARY RESIDENCE

You can sell your primary residence and avoid paying capital gains taxes on the first $250,000 of your profits if your tax-filing status is single, and up to $500,000 if married filing jointly. The exemption is only available once every two years.

Let’s say a single filer bought a home for $250,000, lived in it, and sold it for $400,000 three years later. Their profit is $150,000. But that’s exempt from any capital gains tax, because it’s under the $250,000 threshold allowed for gains.

Of course, there are conditions. To qualify the property as your primary residence, the IRS requires that you prove that it was your main home where you lived most of the time. You’ll need to show that:

- You owned the home for at least two years.
- You lived in the property as the primary residence for at least two out of the five years immediately preceding the sale.

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HOW TO AVOID CAPITAL GAINS TAX ON A RENTAL OR ADDITIONAL PROPERTY

You might find that an investment property you rent and plan to sell has spiked in value. It may be a good idea to move into the rental for at least two years to convert it into a primary residence to avoid capital gains. However, you won't be able to exclude the portion you depreciated while renting the property. You'll lose primary residency status on your main home, but it can always be gained later by moving back in after the sale of the rental property. If you don't plan to sell the main home for at least two years, you can re-establish primary residency and qualify later for the capital gains exclusion.

HOW 1031 EXCHANGE CAN STOP CAPITAL GAINS ON A RENTAL PROPERTY

You can also take advantage of a 1031 exchange. Known as a like-kind exchange, it only works if you sell the investment property and use the proceeds to buy another, similar property. You're basically putting off capital gains tax indefinitely; as long as you keep putting the sale of the proceeds into another investment property, you can avoid capital gains taxes.

HOW CAN YOU BRING DOWN THE COST OF YOUR CAPITAL GAINS TAXES?

If you still have capital gains after taking advantage of exemptions and exclusions, focus on lowering the amount of the taxable profit or gains. Some qualifying deductions include:

- The cost of repairs to a home or investment property.
- Improvements and upgrades, such as adding a bedroom or renovating a kitchen.
- Losses in investment property income due to tenants unable to pay rent.
- Cost of legal, professional, and advertising fees to evict a tenant or find a new one.
- Closing costs from the property sale.

Remember to keep organized records and documents, including receipts, bills, invoices, and credit card statements, to support your expense claims in case you're audited.

For tax advice, please consult with your legal advisor or tax professional

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