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Your Practice

Save tax dollars following the real estate tax rules

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Did you know that two Internal Revenue Service (IRS) Code Sections can actually help you save tax dollars? The exclusion of gain from the sale or exchange of a personal residence under Section 121 and the ability to defer a gain from the exchange of business or investment property through a like-kind exchange under Section 1031 are both options you may want to take advantage of.

Section 121: Sale of Your Personal Residence

When selling a personal residence, you may be able to exclude some or all of your capital gain. First, determine if you qualify. Here are the qualification rules:

1. Two-Year Rule—You must own and live in the residence for at least 24 months out of the prior 60 months.
2. Second Two-Year Rule—You may only use the exclusion once in any two-year period.
3. Principal Residence Rule—The home must be your principal residence. The IRS will look at factors, such as your place of employment, address listed on your tax returns, and location of your banks.

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Residence sales after May 6, 1997 are eligible for up to a \$500,000 tax-free gain if you are a joint filer or \$250,000 if you are single. There are no age restrictions and you can do it an unlimited number of times as long as you do not violate the two-year rules. Also, you are not required to reinvest the proceeds from the sale of your residence.

If you sell your home after a spouse's death, you may also take advantage of a stepped-up cost basis based on the market value of the home on the date of death. By utilizing this option, the surviving spouse may significantly reduce any taxes owed upon the sale of the home.

In addition, you should also be aware that you may receive a proportional exclusion even if you fail either the of the two-year rules. To qualify for the reduced exclusion amount, the sale of your residence must be due to a change in place of employment, health, or unforeseen circumstances.

Section 1031: Like-Kind Exchange of Business or Investment Property

Section 1031 allows a taxpayer to defer the capital gain taxes on the sale of business or investment property if the proceeds are reinvested in like-kind property and the requirements for exchange tax treatment are met. You will not receive tax deferral treatment on the

sale or receipt of personal use property; inventory or property held for sale; stock, bonds, or notes; securities; interests in a partnership; or certificates of trust.

Here are the basic rules you must follow to take advantage of the deferral under Section 1031:

1. The property you sell (relinquished property) and buy (replacement property) must both be held for productive use in a trade or business or for investment purposes and must be like kind.
2. The proceeds for the sale must be held by a qualified intermediary or else the proceeds will become taxable.
3. All the cash proceeds from the original sale must be invested in replacement property. Any unused cash proceeds will be taxable.
4. The replacement property must be subject to an equal or greater level of debt than the relinquished property. If the debt on the replacement property is less than the amount on the relinquished property, the buyer may have to pay taxes on the difference (debt relief).
5. Within 45 days of selling your property you must identify suitable replacement property. You must complete the purchase of your replacement property within 180 days after you have sold your property.

During the 45-day window, you will need to use one of the following methods for property identification:

1. Identify up to three properties as possible replacements for your sold property (“Three-property rule”). Most 1031 exchanges use this rule.
2. Identify an unlimited number of properties as long as the total fair market value of the possible replacements does not exceed 200 percent of the fair market value of the property sold. (“200 percent rule”)
3. Identify any number of possible replacement properties as long as you purchase at least 95

percent of the fair market value of all properties identified. (“95 percent rule”) This is the least flexible and used infrequently.

To meet the like-kind requirements for a real property exchange, the real property must be “like-kind.” Improved or unimproved real property may be exchanged for improved or unimproved real property. To meet the like-kind requirements for an exchange of personal property, the property must be of “like-kind” or “like-class.” The definition of what qualifies as like-kind personal property is much more specific than for real property exchanges.

Some of the advantages of a 1031 exchange include:

- Defer paying capital gain taxes
- Use of leverage
- Opportunity to upgrade or consolidate property
- Diversify by increasing the number of properties you own
- Allow for relocation to a new area
- Opportunity to change property types among residential, commercial, retail

If you are considering either of these tax-saving strategies, consult with your tax, legal, real estate and financial advisor professionals to aid in properly structuring these transactions.

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