

FINANCIAL ADVISORY

Having a Personal Residence with Capital Gains in Excess of Your \$500,000 Exemption? You Can Also Use a 1031 Exchange in the Same Sale!

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Many of my readers are familiar with the IRS Section 121 Exclusion that allows married couples a \$500,000 Capital Gains exemption (\$250,000 for unmarried homeowners) on the sale of their personal residence. If you bought your house 30 or 40 years ago – especially if you bought in a high value area such as California – your capital gain could be much larger than that. The IRS code explicitly allows homeowners to use both the Section 121 exclusion to avoid some taxes altogether AND a 1031 exchange to defer (potentially forever) the rest of your gains – therefore paying no current taxes on the sale of your residence. This month, we'll explore how this works.

THE IRS PUBLICATIONS ALLOWING USE OF A 1031 AND A SECTION 121 EXCLUSION

Rev Proc 2005-14 was described to me as the "Valentine's Allowance" by a tax expert. This

statement provides the basis for using both the Section 121 Exclusion AND a 1031 Exchange to defer taxes from the same sale. The seller must have owned the property for more than 5 years total and must have used the property as a primary residence for 2 of those years.

Rev Proc 2008-16 Section 4.01 states "The Service will not challenge whether a dwelling unit as defined in section 3.02 of this revenue procedure qualifies under Section 1031 as property held for productive use in a trade or business or for investment if the qualifying use standards in section 4.02 of this revenue procedure are met for the dwelling unit. (I have added the underlining and italicized emphasis.) Section 4.02 clarifies that the property must be rented at fair market value for a period of time in each of two 12-month periods before the property is sold – and that personal use cannot exceed the greater of 14 days or 10% of the time the unit was rented at fair market value.

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HOW THIS WOULD WORK IN PRACTICE (A CASE STUDY.)

Let's say a married couple bought a 4 bedroom house in Orange County in the 1980's for \$200,000. Today, this property is worth \$1,600,000: a potential \$1,400,000 Capital Gain. IRS Section 121 will exclude some of that gain completely from taxes - \$500,000 for a married couple, and \$250,000 for an unmarried taxpayer. Our sample taxpayers can take \$500,000 of gains off that bill and are left with a \$900,000 Capital Gain. The 20% IRS Capital Gain Rate plus (starting at) 9.3% California State Tax plus 3.8% Obamacare tax would equal a 33.1%, or \$297,900 tax bill. Ouch!

To defer (potentially forever) this large tax bill, our married couple can move out of their home and operate it as a rental property for two years, then sell the property.

Upon closing, they can take their \$500,000 exemption from the sale and owe no taxes on them. These proceeds can be for any purpose at all - such as a down payment on a new place to live. The balance of the \$1,600,000 sales price, \$1,100,000, contains the

\$900,000 of capital gains. Our investors will defer this gain and their accumulated depreciation (potentially forever) by purchasing a replacement investment property worth at least \$1,100,000 through a 1031 Exchange.

"DOUBLE UP ON TAX SAVINGS WITH AN EXCLUSION AND A 1031 EXCHANGE"

A client recently presented me with a situation that is very similar to our example couple mentioned above. He and his wife are planning to downsize from their current long-term residence, and - faced with a potentially large tax bill - was wondering if there was a way to defer his taxes. I was able to tell him Yes - there is! Not only is it possible to use both the Section 121 Exemption AND the IRS 1031 Exchange in the same sale, the IRS has issued publications that in black and white explicitly say that it is allowed.

Could using both the Section 121 Exclusion and a 1031 Exchange help you to save and defer (potentially forever) taxes on the sale of your personal residence? Call my office at (877) 313-1868 if you'd like to discuss.

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Christopher Miller is a Managing Director with Specialized Wealth Management and specializes in tax-advantaged investments including 1031 replacement properties. Chris' real estate experience includes work in commercial appraisal, in institutional acquisitions for a national real estate syndicator and as an advisor helping clients through over five hundred twenty five 1031 Exchanges. Chris has been featured as an expert in several industry publications and on television and earned an undergraduate business degree and an MBA emphasizing Real Estate Finance from the University of Southern California. Chris began his real estate career in 1998. Call him toll-free at (877) 313 - 1868.

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