

Creative relief

How property exchanges can minimize capital gains taxes **Interviewed by Leslie Stevens-Huffman**

A man's home may be his castle, but given the escalation in residential real estate values in Orange County over the last few years, the castle's sale may generate a substantial capital gains tax bill.

While recent changes in the real estate market have slowed the rate of increase in the average home price, several years of double-digit increases have left many Orange County residents with homes that have more than doubled in value.

At the time it was instituted, the Taxpayer Relief Act of 1997 brought what was thought to be welcome relief for taxpayers. It allows homeowners to exclude up to \$250,000 of personal property gains for single individuals or up to \$500,000 for married couples filing jointly from capital gains taxes. Subject to a two-year waiting period, the exclusion can be used over and over again.

A seller looking to downsize or sell before the two-year waiting period has expired, as in the case of a transfer or promotion, may be in for a surprise.

"I think some people may be startled if they have been carrying forward prior unreported gains resulting from the sale of one or more homes," says Ryan Woodhouse, tax manager with Haskell & White LLP. "In that case, the \$500,000 exclusion may not be adequate, so reducing taxes will call for some planning and creativity."

Smart Business spoke with Woodhouse about the changes in the way home appreciation is handled for capital gains tax purposes and a creative solution to the problem.

What changes are there in the rollover residence replacement rule?

The main difference has to do with the deferral provision of the old pre-May 1997 rollover residence rule versus the exclusion provision currently in place.

The best way to illustrate this is through an example. Let's say that a married couple here in Orange County has purchased and sold homes prior to May 1997, which created deferred capital gains of \$20,000, \$45,000 and \$70,000, for a total of \$135,000.

Because they always bought a more expensive home, the gain is deferred and they avoided any tax consequence from



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the sale under the pre-May 1997 rule. Now, they want to sell their present home, which they purchased in 2000 for \$500,000. It has a current market value of \$950,000. Calculating the tax under the post-May 1997 new rule requires subtracting the previous deferred capital gain of \$135,000 from \$500,000 to arrive at an adjusted cost basis of \$365,000.

After adjusting for improvements and deducting the cost basis from the sales price of the present home, the gain will most likely exceed the \$500,000 deduction, and the balance will be taxed as capital gains.

What is the property exchange solution to capital gains taxes, and how does it work?

If the sellers are to realize gain in excess of the exclusion amount and do not immediately need all of the equity in their homes, such as in the case of trading down residences, converting the property from a primary residence to investment property status may offer an alternative to large capital gains taxes.

IRS 1031 (Like-Kind Exchange Rules) allows for exchanges of investment property without recognizing gain or incurring capital gains tax. The idea is to convert the property from its primary residence status

to a property held for investment. Then the owner can either continue to hold it for the production of income, or exchange it tax-free for another income-producing property.

What steps do you need to take to qualify for a property exchange?

The first step is to make your intentions to change the status of the dwelling from primary residence to investment property clear by leasing the property for a period of time, ideally for a minimum of two years but no longer than three. Once it is clear that the home is now an investment property, it can be exchanged for another income-producing property.

Under the rules of IRS 1031, when a former principal residence is exchanged for a like-kind property, any cash received in the transaction first qualifies under the \$500,000 exclusion, and the balance is excluded from capital gains assessment.

What constitutes a like-kind property exchange?

Generally, this means that income-producing property has to be traded for another income-producing property, such as another residential rental house. One option would be to trade for a similarly priced property that can generate more revenue.

For example, if your home is worth \$1.1 million, it is likely that the net income that could be derived from rental of the high-priced residence is substantially less than the net income that could be derived from a small apartment building that could be acquired in a swap with the \$1.1 million equity value of the residence. If the owner wished to avoid involvement with management of real estate, a trade of the property for high-quality net leased property could be arranged.

All tax laws are complex, and 1031 is no exception. Be certain to consult with a tax professional and evaluate all of your options for dealing with capital gains taxes.

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