TAX SAVING STRATEGIES UTILIZING 1031 EXCHANGES

The 1031 tax deferred exchange is widely known and utilized by investors to defer capital gains tax when selling and buying investment property. To qualify under IRC Section 1031 the basic requirements to maximize your tax-deferral are:

- Acquire “like-kind” property to be held for investment or productive use in a trade or business;
- Identify replacement property within 45 days of closing the relinquished property;
- Reinvest all your cash and acquire replacement property(ies) of the same value or more 180 days from the first closing; and
- Use a qualified intermediary to meet the safe harbor.

There are however, additional tax savings that are not as widely known that can be beneficial when it comes to selling your primary residence or vacation/second home. A few of the strategies are briefly described below and when properly executed can help you save tax dollars.

PERSONAL RESIDENCE TO RENTAL

When a personal residence is sold, IRC section 121 allows for capital gain tax exclusion of up to $250,000 if a taxpayer is single and $500,000 if a taxpayer is married, as long as the residence has been owned and personally used by the taxpayer for an aggregate of two of the preceding five years before the sale. Although this amount is generous, what if you have more gain than the exclusion allows? Rev. Proc. 2005-14 provides guidance for a way to combine Section 121 and Section 1031 to defer taxes on all of the gain.

For example: Rick and Sue a married couple purchased their home for $100,000 20 years ago and it is now valued at $1 million, the taxable gain is $900,000. Upon the sale, the couple would receive their $500,000 exclusion but taxes would be owed on $400,000 of gain. However with the proper tax advice and planning, they could move out of the property and convert it to a rental for a period of time, then they could exclude $500,000 tax free at closing under Section 121, and then perform a 1031 exchange by purchasing an investment property for $500,000 to exclude the remaining $400,000 of gain!

Now they have excluded or deferred all their taxable gain and they own an investment property that could possibly bring them income and/or appreciation.

CONVERTING INVESTMENT PROPERTY TO PRIMARY RESIDENCE

Another tax saving strategy that can be utilized with a 1031 exchange is converting investment property you own to your primary residence. Let’s say that Rick and Sue in the example above exchanged into a rental house. They rented the property for two years (per their tax advisor) and then moved into it converting it into their primary residence. Since they acquired the property in a 1031 exchange and then converted it to their primary

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[1] 26 USC 121(d)(10) [2] 26 USC 121(b)(4) [3] Rev. Proc. 2008-16

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residence, they must own the property at least five years before being eligible for the 121 exclusion.[1] Additionally if they acquired the property in the exchange after January 1, 2009 federal law limits the amount of gain that can be excluded when selling a house used as a primary residence if the house was also used as a rental.[2] While they may not receive the entire $250,000/$500,000 exclusion, they will still reap the benefits of tax savings.

When considering this strategy consult with your tax advisor regarding your specific circumstances to determine the tax free benefits.

QUALIFYING VACATION HOMES FOR 1031 TREATMENT

Many properties are owned as vacation homes, and a common area of confusion has been whether or not a vacation home qualifies for a 1031 exchange. In 2008 a revenue procedure was issued that provides a safe harbor for vacation homes.[3] The following are the requirements under the safe harbor:

- Both the relinquished and replacement properties must have been owned by the taxpayer for at least 24 months immediately before and after the exchange.
- In each of the two 12-month periods immediately before and after the exchange the properties must be rented at a fair market value for 14 days or more.
- The taxpayer's personal use cannot exceed the greater of 14 days or 10% of the days during each 12-month period that the property was rented at a fair market value.
- Personal use includes; the taxpayer's family members, any other person with an interest in the property or their families, anyone using the property under an arrangement which enables the taxpayer to use some other property (even if no rent is charged); or if the property is rented for less than fair market value rent.

With a bit of planning you can take advantage of the1031 exchange and defer taxes on your gain when you sell your vacation home.

Understanding the tax saving strategies available through the 1031 exchange, along with proper planning and tax advice can help you save tax dollars! For additional information about the tax deferred exchange and these concepts contact your local title representative.

[1] 26 USC 121(d)(10) [2] 26 USC 121(b)(4) [3] Rev. Proc. 2008-16

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