

# Tax Rules to Know When Selling Property

**Y**ou may never sell your property, but if you do, odds are you'll have taxes to pay. After all, the real estate market is supposedly coming back. Usually, the longer you hold property, the bigger your gain. The good news is that usually the gain will be capital, meaning a federal tax rate of only 15 percent. But California's tax rates aren't as forgiving, so you'll pay up to a whopping 9.55 percent (in some cases, even 10.55 percent) to the Golden State. That gives you two good reasons to consider whether you can eliminate or defer the tax even if you have a gain.

First, you'll need to distinguish between personal use property, like your principal residence, and investment or business property. As we'll see, sometimes these rules can interact.

If you sell your principal residence and have a gain, it's taxable. The only question is whether you qualify for the special federal tax break. If you have lived there as your primary residence for two years out of the last five, you can shield up to \$500,000 of your gain if you are married and file jointly, or \$250,000 if you file separately or are single.

Incidentally, if you think there's a rollover rule allowing you to pour the gain from selling one principal residence into a new and bigger house, forget it. It was nice while it lasted, but that "trading up" rule hasn't been in the tax law for many years. Still, the \$500,000 exclusion can be used over and over, essentially every two years. You probably don't want to move that often, but if you do, Uncle Sam helps subsidize it.

If you sell business or investment property, you can't use the \$500,000 exclusion. But you can swap the property for other business or investment property tax-free. Section 1031 of the Tax Code allows you to exchange properties tax deferred. California tax law does too. You can roll over the gain again and again. Despite a profit on each trade, you avoid tax until you cash out. Then you'll hopefully only one tax, a capital gain.

The rules are remarkably liberal. You can swap a ranch for an office building, a strip mall for a rental condo. Personal property also qualifies, so you can swap paintings, cars or machinery. There usually isn't even depreciation recapture, although there can be if you swap depreciable property for something that isn't depreciable (say a building for raw land).

You might think a one-for-one swap would be hard to do. After all, how likely is it that a farmer with the farm you want would be willing to swap for your office building? For that reason, the vast majority of exchanges are delayed, three party, or *Starker* exchanges (named for the case that allows them). You'll need a middleman who holds the cash after you "sell" your property.

The middleman will use the cash to buy the replacement property for you. This three party exchange is treated as a swap for tax purposes.

There are several time limits to observe, but the rules are easy to follow. In fact, a whole industry has sprung up around Section 1031 exchanges, so lawyers are often not involved. Yet, since I've seen a few of these go bad, my advice is to get an experienced lawyer just to give the deal a once-over. That's especially true if there is any mortgage debt involved on either side of the deal. A reduction in total debt can be treated like cash, and that usually means tax.

You're no doubt already thinking that you've heard of people using Section 1031 to swap residences. Nope, Section 1031 is for investment or business property. For your principal residence, you can use the \$500,000 exclusion. But what about a vacation home or beach house? The \$500,000 tax break won't help there.

You might consider swapping one vacation home for another under Section 1031. After all, a vacation home is investment property, right? Let's say you swap one vacation home for another under Section 1031. So far, so good. Later you convert the new vacation home to your primary residence. If you live there for two of the last five years, you can use the \$500,000 exclusion, right?

Not so fast. You can still turn a vacation home into rental property so you can do a Section 1031 ex-



**ROBERT W. WOOD** is a tax lawyer with a nationwide practice ([www.woodporter.com](http://www.woodporter.com)). The author of more than 30 books including *"Taxation of Damage Awards & Settlement Payments"* (4th Ed. 2009 [www.taxinstitute.com](http://www.taxinstitute.com)), he can be reached at [wood@woodporter.com](mailto:wood@woodporter.com).

change. Stop using your beach house, rent it out for six months or a year (there's no bright line, but that's probably long enough), and then swap for other investment real estate. What if you merely try to rent it but never have tenants? Timing, intent, and records will be important, but merely *trying* to rent it for six months is probably not good enough.

If you plan to use the newly acquired property as a vacation home or even as your primary residence, consider waiting a bit. The IRS says it won't challenge a Section 1031 exchange based on the investment nature of your new property as long as you actually rent the dwelling at a fair rental for 14 days or more, and if your own personal use of the dwelling doesn't exceed the greater of 14 days or 10 percent of the number of days during the 12 month period the dwelling is rented at fair value.

As to swapping one vacation home or investment property for another, and then making it your primary residence, be careful there too. If you acquire property in an exchange and later attempt to sell it as your principal residence (to claim the \$500,000 exclusion), beware. The exclusion doesn't apply during the five-year period beginning with the date you received the property in the Section 1031 exchange.

Trying to (legitimately) minimize your tax bill is as American as apple pie. Just make sure you dig into the rules carefully - and beware that I've simplified some of the rules here - so don't end up with egg on your face.

*This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.*

