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Tax Breaks On Selling Your Home, Vacation, Or Investment Property

With a personal residence, investment real estate, or other investment property, consider taxes before you sign. Your gain will often be long term capital gain, meaning a federal tax rate of 15 to 20%, depending on your income. Depending on your income, you may have to add another 3.8% in federal taxes. That's the net investment income tax added by Obamacare. President Trump said he would repeal it, but so far that hasn't happened.

That means up to 23.8% in federal tax, which is better than 39.6% on ordinary income. Add your state taxes too. But aren't there breaks to eliminate or defer the taxes? First, you need to distinguish between personal use property, such as your principal residence, and investment or business property. If you sell your principal residence and have a gain, it's taxable. However, 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 gain if you are married and file jointly. The exclusion is $250,000 if you file separately or are single.

Many people ask if there is a rollover rule allowing you to pour the gain from selling one residence into a new and bigger house. However, that "trading up" rule was repealed years ago. Still, the up to $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 can help subsidize it.

If you sell business or investment property, you can't use the $500,000 exclusion. But you may be able to swap for other business or investment property tax-free. Section 1031 of the tax code allows you to exchange properties and roll over your gain into the property you receive in the swap. You can do it again and again. Despite a profit on each trade, you avoid tax until you cash out. Then, you'll hopefully only pay one tax, a capital gain.

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. However, it isn’t clear if swaps of cryptocurrency will qualify. In some swaps, there is depreciation recapture, and debts can sometimes trigger gain too.

A simultaneous one-for-one swap can be hard to arrange. For that reason, the vast majority of exchanges are delayed, three party, or *Starker* exchanges (named for the case that allows them). A middleman 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, so be careful about the details. That's especially true if there is mortgage debt involved on either side of the deal. A reduction in total debt can be treated like cash, and that usually means tax.

Can't you use 1031 to swap primary residences? No, 1031 is for investment or business property. But what about a vacation home or beach house? You might consider swapping one vacation home for another under 1031. You can turn a vacation home into rental property so you can do a 1031 exchange. Stop using your beach house, rent it out for a year (there's no bright line, but that's probably long enough), and then swap for other investment real estate. Some people try this with their primary residence too.

But what if you merely *try* to rent it but never have tenants? Timing, intent, and records will be important. However, 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. The IRS has said that it usually won't challenge a 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 does not exceed the greater of 14 days or 10% of the number of days during the 12 month period the dwelling is rented at fair value.

If you swap one vacation home or investment property for another, and then make it your primary residence, be extra careful. 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 does not apply during the five-year period beginning with the date you received the property in the 1031 exchange. Remember, trying to (legitimately) minimize your tax bill is as American as apple pie. Just make sure you dig into the rules carefully. I've simplified some of the details here. You don't want to end up paying more taxes, penalties and interest later.

For alerts to future tax articles, email me at Wood@WoodLLP.com. This discussion is not legal advice.