

Capital Gains Tax on Real Estate

One of the reasons people choose to use a 1031 tax exchange is to defer paying capital gains tax on their business or investment real estate. Capital gains tax on real estate is defined as the tax levied on profits from the sale of capital assets. Section 1031 of the Internal Revenue Code provides for the deferral of capital gains taxes with a tax-deferred exchange. A 1031 tax-deferred exchange or a like-kind exchange is a method by which a real property owner can sell his property and then reinvest the proceeds in ownership of like-kind property and defer the capital gains tax. The process gives the 1031 exchanger more buying power because the capital gains taxes are deferred. Capital gains taxes on the sale of the property are deferred until the like-kind property is sold at a future date.

To estimate your capital gains tax on real estate, use our capital gains calculator on <http://www.teamshafagh.com>. *(Simply click on Mortgage Calculator on the Navigation Bar)* This calculator will help to determine the amount of capital gains tax due if you were to sell your property. However, this information is not intended to replace qualified legal and/or tax advice regarding capital gains taxes. Each buyer should review any investment or transaction with their own legal and/or tax counsel to determine the amount of capital gains they owe.

To qualify as a like-kind exchange and avoid capital gains taxes, property exchanges must be done in accordance with the rules set forth in the tax code and in the treasury regulations. In order to defer all capital gains tax in a like-kind exchange, the real estate buyer should follow these guidelines:

- The 1031 tax exchange proceeds must be reinvested in the acquired property and the acquired property must have the same or greater value.
- Obtain equal or greater equity in the replacement property.
- Obtain equal or greater debt in the replacement property or have a reduction in debt that is offset with additional cash at closing from the taxpayer.
- Receive nothing except like-kind property.

Besides deferring capital gains tax, there are numerous other benefits of a 1031 exchange.

Why should you consider a 1031 exchange?

- Defer paying capital gains taxes.
- Leverage.
- A properly structured exchange can provide real estate investors with the opportunity to defer all of their capital gains taxes. By exchanging, the investor essentially receives an interest-free, no-term loan from the government.

- Relief from property management. The lessee takes the responsibility to sublet and maintain the property allowing real estate buyers to avoid most of the day-to-day management headaches.
- Upgrade or consolidate property.
- Diversify. Own multiple properties rather than just one.
- Relocation to a new area.
- Differences in regional growth or income potential.
- Change property types among residential, commercial, retail, etc.

What are the 1031 exchange rules?

1. The real property you sell and the real property you buy must both be held for productive use in a trade or business or for investment purposes and must be like-kind.
2. The proceeds from the sale must go through the hands of a qualified intermediary and not through your hands or the hands of one of your agents or else all the proceeds will become taxable. **
3. All the cash proceeds from the original sale must be reinvested in the replacement property - any cash proceeds that you retain will be taxable.
4. The replacement property must be subject to an equal level or greater level of debt than the relinquished property or the buyer will either have to pay taxes on the amount of the decrease or have to put in additional cash funds to offset the lower level of debt in the replacement property.

****The role of the Qualified Intermediary (QI)**

The QI is a person or entity that can legally hold funds to facilitate a 1031 exchange. To be qualified, the intermediary must not be relative or agent of the exchanging party. As an exception, a real estate agent may serve as an intermediary if the current transaction is the only instance in which the agent has represented the exchanging party over the past two years.

The use of a QI is essential to completing a successful 1031 exchange. The QI performs several important functions in the 1031 exchange process including creating the exchange of properties, holding the exchange proceeds and preparing the legal documents.

1031 timelines

Identification Period: Within 45 days of selling the relinquished property you must identify suitable replacement properties. This 45 day rule is very strict and is not extended should the 45th day fall on a Saturday, Sunday, or legal holiday.

Exchange Period: The replacement property must be received by the taxpayer within the "exchange period," which ends within the earlier of . . . 180 days after the date on which the taxpayer transfers the property relinquished, or . . . the due date for the taxpayer tax return for the taxable year in which the transfer of the relinquished property occurs. This 180-day rule is very strict and is not extended if the 180th day should happen to fall on a Saturday, Sunday or legal holiday.

Replacement property identification

3-property rule: You may identify any three properties as possible replacements for your relinquished property. More than 95% of exchanges use the 3-property rule.

200% rule: You may identify any number of properties as possible replacements for your relinquished property as long as the aggregate value of those properties does not exceed 200% of the value of your relinquished property.

95% exemption: You may identify any number of properties as possible replacements for your relinquished property as long as you end up purchasing at least 95% of the aggregate value of all properties identified.

Primary Residence

Section 1031 Exchanges

Taxpayers have been able to structure the sale or disposition of an investment property and the subsequent acquisition of another investment property as a 1031 exchange for many years. The 1031 exchange allows a taxpayer to defer his or her depreciation recapture and capital gain income tax liabilities when selling or disposing of one or more investment properties ("relinquished property") and acquiring one or more like-kind investment properties ("replacement property").

The only thing better than the deferral of income taxes is the ability to permanently exclude them all together.

Section 121 Exclusions

Taxpayers have been able to sell or dispose of a primary residence and exclude from taxable income up to \$250,000 in capital gains if a single taxpayer or up to \$500,000 in capital gains if married and filing a joint income tax return under the 121 Exclusion. The 121 Exclusion is a permanent exclusion from taxable income (i.e. tax free; not tax deferred) and is a fantastic tax planning tool for taxpayers to use.

The requirements for a 121 Exclusion are fairly simple. The taxpayer must have owned the property and lived in the property as his or her primary residence for at least 24 months out of the last 60 months in order to exclude the capital gain from income. The taxpayer can take advantage of the 121 Exclusion once every two years.

In fact, many taxpayers do not – and should – pay close attention to the market value of their primary residence and the corresponding capital gain in their primary residence in order to determine if they should sell and lock in the tax free benefits of a 121 Exclusion. The amount of capital gain in excess of the \$250,000 or \$500,000 limitation will be generally be taxable, so they should at least consider selling when their capital gain is approaching this exclusion limitation.