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Real Estate Tax Breaks: Save Thousands of Dollars in Taxes

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In December 2002, the IRS published the long awaited regulations outlining the rules which permit homeowners to exclude up to \$500,000 of capital gain on the sale of their principal residence. If homeowners have owned their home for two years, and have used it as their principal residence for a total of two years over the past five year period, they can exclude, if filing separately, up to \$250,000 of gain, and if married filing jointly, they can exclude up to \$500,000 of capital gain. For homeowners this is an absolutely wonderful tax break.

The new regulations also provide specific instructions for claiming a tax exclusion if the homeowner does not meet the two-year use or ownership criteria when they need to sell their property. Also newly covered is the business use of a part of your personal residence and the sale of adjacent vacant lots. While these instructions are detailed, they are very favorable toward the homeowner. If you are thinking of selling your home and do not meet the two-year criteria, you should be certain to check the new regulations.

Another little known tax break for owners of investment, business, or rental property is a like-kind exchange under Internal Revenue Code 1031. A like-kind exchange is also known as a tax-deferred, tax-free, or Starker exchange. If you are thinking about selling your real estate investment, rental, or business property, you need to investigate this tax break. The IRS 1031 regulations permit you in a like-kind exchange to roll over the gain from your current investment property into a new property that will also be held for investment, business or rental purposes. You can exchange real estate for any other real estate, such as vacant land for a residence or a rental house for an office building.

To determine the amount of federal tax you will have to pay if you sell your investment property and do not do an exchange, you can use the "[Gains Calculator](#)" on our website www.1031.us. Remember: the capital gain on real estate is not only the profit made but the recapture of all the depreciation taken over the years.

After settlement of the relinquished property, the investor has 45 days to identify potential replacement properties and up to 180 days to purchase one or more of the properties identified. To have a tax-free exchange, the replacement property needs to meet the reinvestment requirements. These two requirements are simply:

1) The cost of the replacement property(ies) must equal or be greater than the value of the relinquished property(ies) less the selling costs; and

2) All of the cash equity received must be reinvested in the new replacement property(ies). If the investor does not purchase property of equal or greater value or does not reinvest all the cash equity, the difference, whichever is greater, will become taxable capital gains income. The "Gains Calculator" also shows the reinvestment requirements.

It is important to note that the new replacement property may not go to settlement before the settlement of the relinquished property(ies). However, in the fall of 2000, the IRS provided instructions so that an investor can make arrangements with an Exchange Accommodation Titleholder (EAT) to get control of a desired replacement property before the closing of the relinquished property. While this reverse exchange process is complex, it does insure the investor that the desired replacement property will be available when the relinquished property is finally sold.

To insure a successful "safe harbor" exchange, the IRS regulations require the use of a qualified intermediary (QI). The rules are complex and an investor should use a professional qualified intermediary such as Realty Exchange Corporation, which has been in business since 1990 and is the largest exclusive qualified intermediary service in the mid- Atlantic. It is important to know that the IRS requires the exchange and escrow account agreement, the assignment document, and the notification of assignment be in place prior to the closing and transfer of the relinquished property. The escrow account agreement also provides for the exchange escrow funds to be wired directly from the settlement office to the qualified escrow account held by the qualified intermediary.

For a free copy of the new homeowner regulations, to be placed on the Exchange News newsletter mailing list, or receive an information package on like-kind exchanges, call Realty Exchange at 800-795-0769, or e-mail us at bill@1031.us.

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