

The Virtues of Patience: Eliminating Capital Gains Taxes Possible with Advance Planning

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A question we frequently hear deals with combining Sections 121 and 1031 of the Internal Revenue Code to avoid capital gains taxes. If your principal residence has appreciated in value beyond the \$500,000 gain exclusion provided under Section 121 of the Internal Revenue Code, are you stuck paying taxes on the profits over \$500,000? Not with some flexibility and advanced planning.

Under Section 121 of the Internal Revenue Code, you can exclude up to \$500,000 in gain for married couples (\$250,000 in gain for singles) on the sale of a principal residence, as long as it has been occupied as a principal residence for two out of the last five years.

Under Section 1031 of the Code, you can defer all capital gains taxes by exchanging an income or investment property into another income or investment property of equal or greater value.

The obvious next question is: How do you convert a principal residence into an income or investment property? It's quite simple: move out of your principal residence and rent it out, or make it available for rent for at least a year and a day.

Why at least a year and a day? There is an old Revenue Ruling from the IRS that says that a two year holding period is sufficient to qualify a property as being held for income or investment purposes. The IRS hasn't said how much less than two years will qualify. We feel comfortable with a holding period of at least a year and a day, because that time period puts you into both a second calendar year and a second tax year.

If you move out of your principal residence and rent it or make it available for rent for at least a year and a day, it will then qualify as 1031 property. Sell the property and exchange it into a new property, which must also qualify as income or investment property. Hold your new property for income or investment purposes for at least a year and a day. Then move into it and make the new property your principal residence. You have accomplished the sale of the old property and the move into your dream home without paying any taxes on your gains!

Daniel McCabe, Esq. is Vice President of Exchange Resource Group, LLC (ERG), which provides a full range of services for Section 1031 tax deferred exchanges, including consulting on complex exchange techniques. He is a national speaker for 1031 Exchanges and is Past President of the Federation of Exchange Accommodators (FEA), the national trade organization for the 1031 industry. ERG is located in Denver, Colorado, with consultants in Arizona, California, Florida, and Texas. Call 303.789.1031 for a free consultation or visit www.erg1031.com.