Avoiding Capital Gains Tax

Last month we talked about capital gains taxes, the exclusion of $250,000 (single) or $500,000 (married-filing jointly) of gain from being taxed, and the ability of investors to defer gain by reinvesting in like-kind property to the property they sold.

Of course, there are situations (especially in the Bay Area) where the primary residence of many homeowners exceeds the exclusion amount. What can they do to sell their home, yet not pay the capital gains tax?

Let's look at a few examples of some situation that occurred recently.

1. A couple were selling their home in Dublin. They had owned and lived in the property for 2 years, since the day they closed escrow. They thought that they could now sell, and take their exclusion. The problem was that they had sold another property, which had closed escrow approximately 3 months after they purchased their current home. They had used the primary residence exclusion on the previous property, meaning they could not do so again for 2 years.

   Although they had already made another purchase, which was almost ready to close escrow, they could not sell their current residence for another 3 months. Fortunately they were able to close escrow on the purchase, and continue to live in their old home for those 3 months. It resulted in double mortgage payments, but that was better than the alternative of paying capital gains tax.

2. A woman had resided in her home for 18 of the past 20 years. She had a converted it to a rental 2 years earlier. When she wanted to sell it, she was told that the property could either be considered a primary residence (allowing a primary residence exemption), or a rental property (which would allow for a §1031 tax deferred exchange).

   Her basis was about $150,000, and the selling price was $540,000, meaning if she treated it like a primary residence, she would be taxed on $140,000 in gain. If she did a §1031 exchange, she would be required to use all of her funds on a new property for rental. In reviewing the Internal Revenue Code, there was nothing that would specifically prohibit her from treating the property as both. It qualified as a primary residence, and as investment property.

   Since there was no clear cut authority either way, she took a chance and sold the property as partly a primary residence, and partly an investment property. Fortunately, the next month, IRS issued a revenue ruling Rev. Proc. 2005-14) which allowed the double classification of property as both a primary residence and an investment property, as long as they qualified for both at the time of sale (meaning it must be a rental at the time of sale).

3. A couple built a custom home in 1984 in Pleasanton. The basis of the property was approximately $600,000, but it was now worth $1.7 million. Probably, not the kind of house that one would want to convert to a rental. Obviously, they could take the $500,000 exemption, but had a reportable capital gain of $600,000! This would result in a tax of approximately $150,000 on the transaction.

Instead of paying the tax, the couple created a charitable remainder trust, and deeded a portion of the property into the trust. When the property sold, $600,000 went into the charitable trust, tax free. During their lifetimes, they received all of the income from the trust, with the remainder going to the charity after their deaths. There are also additional things they could have done to insure an inheritance for their children as well.

They received the remaining funds without tax, and an income for life from the trust.

Capital gains tax rules, along with IRC §121 and §1031, are complex and great care should be exercised when discussing them with your clients. Generally, it is better to have them talk with a CPA or tax attorney.

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