

## Avoiding Capital Gains Tax

It is very surprising when I learn how many people (Realtors and homeowners) are confused about capital gains tax liability.

For example, many people think that capital gains taxes are computed based on the difference between their loan amount and the selling price of the home. Actually, the capital gain on the sale of real estate is based on the selling price of the home, minus the “adjusted basis”. The adjusted basis is the original purchase price, plus the costs paid at the time of purchase, improvements made to the property during ownership, plus repairs made in anticipation of sale, plus selling expenses paid by the seller. If someone had refinanced a number of times, their basis may be significantly less than the loan value.

Another area of confusion is that homeowners think that they can avoid taxes by reinvesting in another property. That was available under the old IRS Code, but was abolished in 1997. Today, someone selling their primary residence has an exemption of either \$250,000 (single or married, filing separate) or \$500,000 (married, filing jointly). Of course, as with every gift from IRS, there are specific rules.

1. Must have owned and lived in the property for 2 of the past five years. These do not need to be consecutive years, or the last 2 years, as long as it has been owned and lived in as a primary residence for 2 of 5 years. So, one could purchase a house in June of 2001, live in it for a year, then move out and rent it for 3 years. If they move back in by June of 2005, they can then sell it in June of 2006 and take the exemption.

In the past few years, there has been some significant appreciation, which has caused some people to “cash-in”. If they sell before they have lived in the house for 2 years, they will have a capital gain tax liability. A good agent will look at a property profile of the property to determine when the seller moved in, and advise them to seek tax advice if they have lived in and owned the property less than 2 years.

2. May not have used the exemption on another property within the past 2 years. This is a very important rule. I once had a situation where a family was selling the condo which had served as their primary residence for the past 2 years. The problem is that they had moved into the condo about 3 months before their previous primary residence had sold. If they had relied simply on the fact that they had lived in the condo for 2 years, they would have been faced with capital gains tax on a significant amount of appreciation.

3. A married couple filing a joint return can claim the \$500,000 exemption, even if only one of them was on title to the property, as long as they both meet the requirement that they lived in the property for 2 of the past 5 years. They don't even need to be married at the time of the sale, as long as they are married before the end of the year and file a joint return for the year of the sale.

4. Recently, an Internal Revenue Ruling decided that if a taxpayer acquires a property through a IRC §1031 Tax Deferred Exchange, and then convert it to a primary residence, they may not make use of the \$250K/\$500K exemption unless they have owned the property for 5 years. In other words, one cannot exchange a rental property in an area they would not normally want to reside into another that they would be willing to live in

for two years, and then convert it to a primary residence with the intent of selling 2 years later and taking the capital gains exemption.

These guidelines are strictly adhered to by IRS, partly because they are such a great advantage to homeowners and tax payers. The same holds true for investment property and §1031 Tax Deferred Exchanges. This is an area of scrutiny with IRS and likely to trigger an audit to make sure all of the rules and regulations have been met.

Next month we will talk about delaying capital gains taxes through §1031 exchanges, how to combine the primary residence exclusion with §1031 and ways to avoid payment of capital gains taxes when gain on a primary residence exceeds the \$250K/\$500K exclusion amount.

*Ken Koenen is a tax attorney at Koenen & Tokunaga, P.C., and a licensed real estate broker in Pleasanton. He can be reached by phone at 925-924-0100 or email at [ken@ktpclaw.com](mailto:ken@ktpclaw.com)*

© 2006, Ken Koenen, Koenen & Tokunaga, P.C.