

keep deferring your taxes



Why would you pay your taxes now when it's in your best interest to defer them until later? Your capital gains taxes as a homeowner can be deferred for years into the future— and in the meantime that money can be responsibly invested... to make you more money!

As Advisor Jennifer Pendzick noted during a recent lecture at Lieb at Law's Real Estate School, too many home seekers and home owners are missing the opportunity of tax deferral through a 1031 Exchange. Ms. Pendzick says that "people just aren't aware and taking advantage of the 1031 Exchange benefits." During the "Intro to Commercial Real Estate" class lecture, she demonstrated the lost value. She said that a home that appreciated \$100,000 during the period of ownership would have federal capital gains taxes of \$15,000 and the state taxes would be \$6,850. Ms. Pendzick explained that federal capital gains tax is currently at 15% (and it's slated to increase to 20% in the coming year) and NYS capital gains tax is 6.85%. That's a lot of money in taxes that can be deferred into the future in a way that is similar to the mechanics of a 401(k)- in both a 401(k) and a 1031 Exchange, the investor gets the benefit of appreciation on tax dollars while they remain investing. Thus instead of paying the government \$16,850 and getting nothing, the owner can use this money to buy a more expensive replacement house getting even more return on future appreciation. Strategically smart. Perfectly legal.

The reason that Ms. Pendzick focused on second homes rather than discussing all residences is that primary residence capital gains tax is governed



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by another, more friendly, section of the Internal Revenue Code, 121, whereby a homeowner is exempt from the first \$250,000 of capital gains and a married couple can avoid \$500,000. Yet, section 121 is not available for second homes. So a 1031 Exchange strategy is required to combat capital gains taxes on such a home. Yet, a 1031 Exchange is only available for investment property, not for property intended for personal enjoyment. Therefore, it's important to focus on the homeowner's intent upon the initial purchase and for real estate agents and lawyers to educate purchasers

on how to document their true intent.

Any taxpayer contemplating an Exchange of their second home should be able to substantiate that their primary objective was investment, not personal use. Supporting documentation should be put in place early, such as efforts to rent the property and/or rental income being reported on tax returns. Also, documented business meetings at the home may prove helpful. Additionally, the property could have been purchased for appreciation value, another form of investment, which again would require supporting documentation, such as appraisals or the like to substantiate fair market value and market trends. Yet, utilizing these techniques is not full proof and a homeowner may end up in Court fighting with the IRS if they are not extra careful.



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In such, the IRS offers a full proof approach to qualify a second home for a 1031 Exchange where no risk exists for a homeowner. Specifically, Revenue Procedure 2008-16 states that a property was held as an investment if: (1) The relinquished property is owned by the taxpayer for 24 months immediately prior to the Exchange and a replacement property is owned for at least 24 months immediately after the Exchange and (2) Within each of the two years immediately prior to the Exchange, the taxpayer must: (A) Rent the property to another person(s) at a fair rental for 14 or more days; and (B) The taxpayer's personal use of the dwelling unit cannot exceed the greater of 14 days or 10 percent of the number of days during the 12 month period the dwelling unit is rented at a fair rental.

Yet, even with these tax strategies, it's necessary that a homeowner hires experts to assist in a transaction utilizing a 1031 Exchange because executing a flawless Exchange is overly technical. So, the homeowner should look for three different experts to facilitate their transaction: a real estate agent, an attorney, and a qualified intermediary (who holds the sales proceeds until a new purchase happens to complete the Exchange.)

Register for the next real estate class at
www.liebatlaw.com/realestateschool/register
to learn more about 1031 Exchanges.

Andrew M. Lieb is the Managing Attorney of Lieb at Law, P.C. and of the firm's NYS Licensed Real Estate School. You can reach Mr. Lieb with questions or comments at Andrew@liebatlaw.com or 631.878.4455. Please see our website at liebatlaw.com to register for FREE real estate continuing education classes.