CPA Practice Advisor

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their homes.

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Since the beginning of the COVID-19 pandemic, median home prices in the United States have skyrocketed, increasing by 41.6% from March 2020 to July 2023 as inventories have declined, according to the National Association of Realtors. The pandemic-driven shift to remote work, increasing demand for suburban and rural

homes, and formerly low interest rates combined to accelerate demand and home

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For taxpayers who find themselves in this situation, thoughtful tax planning is essential. One possible solution could be a like-kind exchange (Internal Revenue Code (IRC) Section 1031). Here's how this home sale strategy can help your clients be more tax savvy while navigating today's real estate market.

Understanding the Tax Consequences

Capital gains tax should be a significant consideration when selling an appreciated home. It applies to the profit made from the sale and is categorized into two types: short-term capital gains and long-term capital gains. Short-term capital gains are applied to properties held for one year or less, while long-term capital gains apply to properties held for more than one year.

Short-term capital gains are taxed at ordinary income tax rates, which can be significantly higher compared to long-term capital gains. Long-term capital gains typically benefit from preferential tax rates of 0%, 15%, or 20%, depending on your client's taxable income and filing status. Married filing jointly (MFJ) couples can qualify for the 0% capital gains tax rate if they have 2023 taxable income of less than $89,249. If they have taxable income of more than $89,250 but less than $553,849, they qualify for the 15% capital gains tax rate. If their taxable income is more than $553,849, they'll qualify for the top 20% capital gains tax rate.

A taxpayer may also be subject to an additional 3.8% surtax on net investment income (NII) on a sale. NII includes capital gains, dividends, taxable interest, annuities, royalties, passive rents, and certain income from passive activities, and it increases the top tax rate to 23.8% on long-term capital gains. The NII tax, commonly referred to as the "Medicare surtax," applies to MFJ filers with modified adjusted gross incomes (MAGIs) exceeding $250,000 and to single filers with MAGIs exceeding $200,000. These income thresholds aren't indexed for inflation, so an increasing number of people are subject to the tax. If your client is in a high-tax state,

the combined capital gains, NII, and state taxes could exceed 30% on the realized

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no capital gains tax associated with the sale because of the step-up in basis to fair market value. For your clients who want to hold on to their homes long term, this could be the best tax strategy.

The Home Sale Exclusion Rule

The Taxpayer Relief Act of 1997 repealed a longstanding rollover rule that allowed homeowners to defer recognition of capital gains from the sale of a principal residence. Instead, the replacement Home Sale Exclusion Rule permanently eliminates the tax on capital gains realized up to $500,000 for MFJ taxpayers and $250,000 for single taxpayers. For your clients to qualify, the property being sold must be their primary residence and they must have lived in it for at least two of the last five years before the sale.

The Like-Kind Exchange

A like-kind exchange (IRC Section 1031) allows the seller to defer capital gains taxes by reinvesting the proceeds from the sale of the real estate held for investment into a similar real estate investment property. To qualify, your client must meet several requirements. For example:

- Rental real estate is considered like-kind property; real estate investors can exchange rental property for other rental property.

- To obtain fully tax-free treatment on the exchange, the replacement property must be identified within 45 days of the sale of the relinquished property, the cash proceeds from the exchange must be fully applied toward the acquisition of the replacement property, and the value of any debt on the relinquished property must be replaced with equal value on the replacement property.
- Both the relinquished property and the replacement property must be held for investment or used for productive use in the taxpayer's trade or business. This is

important to prove intent should the business purpose of the exchange be called

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- The relinquished dwelling unit must be owned by your client for at least 24 months immediately before the exchange.
- Within the 24-month qualifying use period, in each of the two 12-month periods immediately before the exchange, your client must rent the dwelling unit to another person(s) at a fair rental rate for 14 days or more.
- The period of your client's personal use of the dwelling unit must not exceed the greater of 14 days or 10% of the number of days during the 12-month period that the dwelling unit is rented at a fair rental rate.
- The replacement property must continue to be owned by your client for at least 24 months immediately after the exchange. Similar rules for rental and personal use (as noted above) will apply to the new property following the exchange.

If your client meets all Rev. Proc. 2008-16 safe harbor requirements, the IRS will not challenge the IRC Section 1031 transaction. This allows a taxpayer to defer the recognition of a capital gain on the exchange. The tax basis of a home exchanged would carry over to the new property.

Conversion of a Vacation Home to a Primary Residence

After the two-year requirement is met, your client can convert the investment property to a primary residence. However, upon later sale of the new residence, some of the gain could be ineligible for the home sale exclusion. The ineligible portion of the gain would be based on a ratio of the time that the home was a second residence or investment property, to the total time that your client owned the property. The remaining gain would be eligible for the $250,000/$500,000 home sale exclusion.

Finally, IRC Section 1250 depreciation recapture rules could apply to a later sale if your client took depreciation deductions on the property while it was a rental. When depreciable real estate is held for more than a year and sold at a gain, previously

deducted depreciation must be recaptured and taxed at a 25% top rate. Of course, if

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Taxes

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