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TRICKS OF THE TRADE

REDUCING CAPITAL GAINS ON YOUR VACATION HOME

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Many homeowners also own vacation homes and are sitting on tax time-bombs. These vacation homes are often located at shore points along the beaches of New Jersey, Delaware, and Maryland. For those who have owned their properties for a long time, they have likely seen a significant appreciation in the value of their property. As such, the sale of that property could result in capital gains taxes that can be tens of thousands of dollars, or more. In this month's "Tricks of the Trade", we present three alternatives that can reduce, or even eliminate those capital gains.

1. Establish your vacation home as your primary residence – Federal (and most state) laws allow for tax breaks when selling your primary residence. Specifically, the IRS allows for a $250,000 exemption if you have lived in your home for at least two of the last five years, and that exemption is doubled if you're married. Thus, a married couple can sell their home and reduce their capital gain by $500,000, which often eliminates the capital gain entirely.

   To do so requires that the homeowner demonstrate residency, such as voter's registration, driver's license, and utility bills in their name at that address. So, if a couple intended to sell both their primary residence AND their vacation home, they could sell their primary residence first, and then move to the vacation home and live there for two years prior to selling it. Alternatively, they could establish their residence at their vacation home for two years, sell it, and move back to their other residence. There may be other scenarios that could also fit the homeowner's circumstances.

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2. Complete a 1031 Exchange – A 1031 exchange is when you sell one property, and buy another, and "transfer" the capital gains from the first property to the second property. This sounds simple at first, but there are a multitude of complexities and rules that must be followed. First, a 1031 exchange can only be applied to business properties (such as rental properties), so your vacation home will need to become a rental property first. Second, a qualified 1031 exchange company should be used to facilitate this complex process, which includes a third party serving as an intermediary. The second property must be identified prior to the sale of the first property, the second property must be purchased within a specified time frame, and the proceeds of the sale of the first property must be held in escrow. The details of the 1031 exchange process are beyond the scope of this article, but it is imperative that every rule is followed, or else the deferral of the capital gains will be disallowed by the IRS.

3. Leave the property to your heirs – Under current IRS laws, the value of the decedent's property (which includes stock, as well as real estate) receives a "step up" in basis. In short, the beneficiaries inherit the property at its fair market value at the time of death, thereby eliminating capital gains. This can be tricky in many situations, as the owner may need to equity in the property during their lifetime for a variety of reasons. However, if there is no need for the equity in the home (or the value of other appreciated assets), then it may be in the best interest to NOT sell the property during the owner's lifetime. It is important to note that if the owner of the property gifts the property to their children (or anyone, for that matter), then the cost basis is also transferred to the new owner, and does not receive a step up at the time of death of the original owner.

As you can see above, there are a multitude of ways in which the owner of a highly appreciated property can legally mitigate capital gains taxes on their property. It is also important to note that a combination of the ideas noted above can also be utilized. If any of these situations apply to you, we strongly encourage you to speak with your qualified financial advisor or tax professional.