Building Wealth
By Unlocking Tax Equity In
Real Estate! ™©2006

Part I – Real Estate Tax Basics

[EXCLUSION OF GAIN ON SALE OF PERSONAL RESIDENCES; IRC 121, CONVERTING INVESTMENT RENTAL REAL ESTATE OR PERSONAL REAL ESTATE, IRC 1031 TAX DEFERRED EXCHANGES]

By Richard Ivar Rydstrom, Esq., LL.M.
Dean & Professor of Law, J.D., LL.M. Taxation
949-678-2218 | rrydstrom@gmail.com

Homeowners have the most tax efficient method of building wealth in America today. Not only is the cost of financing (loans) most favorable to the homeowner, but the tax laws allow a homeowner to exclude under IRC 121, $250,000 (or $500,000) of gain on the sale of a personal residence. Better yet, the tax laws allow you to buy additional properties and "time" your purchases and sales without paying current tax, in part, by combining the IRC 121 with the 1031 tax deferred exchange. Keep in mind the tax laws also allow you to "convert" the "use" of property to or from personal to business rental. With a little planning, this will allow further tax deferred wealth building.

SEC. 121. - EXCLUSION OF GAIN FROM SALE OF PRINCIPAL RESIDENCE:

Significant tax benefits are provided by the tax law changes in the 1997 Taxpayer Relief Act for the sale of a personal residence. The tax law known as IRC 121 allows the homeowner to ***unlock the full equity*** in the home once, without losing the ***taxable equity***, every two years!

IRC Section 121[1] - states under provision “(a) Exclusion” that:

> “Gross income shall not include gain from the sale or exchange of property if, **during the 5-year period ending on the date of the sale or exchange**, such property has been owned and used by the taxpayer as the taxpayer's **principal residence for periods aggregating 2 years or more**.”

KEY: One of the key aspects of the test overlooked by most homeowners is that you only have to use the home as your personal residence for a **total of 2 years out of the last 5 years!**

IRC Section 121 under section “(b) Limitations, (1)” goes on to state:

> “The amount of gain excluded from gross income under subsection (a) with respect to any sale or exchange **shall not exceed $250,000**.” IRC Section 121, section “(2) allows a **$500,000 exclusion** from gain for a husband and wife filing a joint tax return.

KEY: It is key to understand that the law states that “(i) either spouse meets the ownership requirements of subsection (a) with respect to such property;”[2]

KEY:Each spouse shall be treated as owning the property during the period that either spouse owned the property.[3]

KEY: If either spouse meets the ownership and use requirements with respect to such property, and file a Joint Tax Return, the exclusion may be claimed.

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[1] Internal Revenue Code (“IRC”); TITLE 26, Subtitle A, CHAPTER 1, Subchapter B PART III Sec. 121

[2] “(i) either spouse meets the ownership requirements of subsection (a) with respect to such property; (ii) both spouses meet the use requirements of subsection (a) with respect to such property; and (iii) neither spouse is ineligible for the benefits of subsection (a) with respect to such property by reason of paragraph (3).

[3] “(B) Other joint returns - If such spouses do not meet the requirements of subparagraph (A), the limitation under paragraph (1) shall be the sum of the limitations under paragraph (1) to which each spouse would be entitled if such spouses had not been married. For purposes of the preceding sentence, each spouse shall be treated as owning the property during the period that either spouse owned the property.

KEY: **You are limited to <u>only 1</u> sale or exchange every 2 years !**[4]

KEY: **You Need To "Time" Your Moves Accordingly!**

<u>IRC 1031 TAX DEFERRED EXCHANGE RULES – NOT FOR PERSONAL USE PROPERTY:</u>

Section 1031 is used by most every investor in real estate to build great wealth. IRC 1031 allows the property owner to sell (or exchange) property **<u>held for productive use in a trade or business (IRC 1231) or for investment (IRC 1221 – Capital Asset) (including "rental properties")</u>**[5] - for another "like-kind" property, without paying current taxes! This allows the amounts that would have been paid in taxes upon that sale to build up in the equity of the property. Now you can afford to buy more real estate than you would have, had you sold and paid taxes at the time of the sale, and then purchased another property. This is the most common wealth building technique in real estate.

Investment property is <u>rental properties</u> whether commercial (nonresidential) or residential; <u>vacation homes "held for profit or resale"</u> (not held for "personal use"), <u>investment (portfolio) real estate</u> (IRC 1221), leasehold interest (lease term exceeds 30 years including options to extend or renew) [RR 1.1031(a)-1(c)], and vacant land.

WARNING! - PROPERTY <u>NOT ELIGIBLE</u> FOR 1031 EXCHANGE:

Personal Residence (your personal residence is a capital asset <u>but</u> it is not used in a trade or business and it is not held for investment purposes, it is held for "personal use" and does <u>not</u> qualify for 1031 treatment)

Flippers or Dealer Property; such as inventory, real estate bought with the intent for resale (Buy Flip), [IRC 1031(a)(2)(A)]

Stock (but not capitalization stock under IRC 351/1032) [IRC 1031(a)(2)(B)

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[4] "(3) Application to only 1 sale or exchange every 2 years - (A) In general
Subsection (a) shall not apply to any sale or exchange by the taxpayer if, during the 2-year period ending on the date of such sale or exchange, there was any other sale or exchange by the taxpayer to which subsection (a) applied."

[5] IRC 1031 (a)(1)

Bonds (such as certificates or interest bearing debt from corporations or governments) [IRC 1031 (a)(2)(B)]

Seller Carry-Backs, Promissory Notes (secured or unsecured, sold or purchased including seller financing notes or carry back notes) {IRC 1031 (a)(2)(B)]

Securities, Post Dated Checks (security devices or indicia of indebtedness, assignments of payment rights held by trust deed lenders, post dated checks, etc.) {IRC 1031 (a)(2)(C)

Fractional Interests (joint venture or partnership co-ownership arrangements) (not partnership interests exchanged under tax free IRC 721) [IRC 1031 (a)(2)(D)

Foreign Real Estate (property located outside the United States [IRC 1031 (h)

Beneficial Interests in a Trust (but not a Revocable Inter Vivos or Living Trust) [IRC 1031 (a)(2)(E)

Choses In Action (payment rights, rights to receive future payments, assignable seller's interest in purchase agreement) {IRC 1031 (a)(2)(F)

COMBINING IRC 121 and IRC 1031:

Savvy homeowner/investors are combining **IRC 121 and IRC 1031** to get a maximum tax benefit as they unlock equity and trade up in real estate.

Mixed Use: For example, one could start out in real estate by purchasing a 4 unit rental / investment property, and live in one unit. When selling same, the one unit held for personal use would qualify for gain exclusion under IRC 121 ($250,000 / $500,000), and the other 3 units would qualify for a 1031 exchange (tax deferred with no current taxation).

Converting: For example, one could exchange into a replacement "rental" property under IRC 1031 (that was initially "held for investment"), but later "converted" into a primary residence to afford use of the IRC 121 exclusion of gain rules. As stated above, IRC 121 requires that a homeowner live in the property as a "personal residence" for 2 years out of a 5 year period before sale. If you in fact did so, you would have converted the use from a rental ("held for investment") to "personal use", affording you the use of the IRC 121 gain exclusions.

CREATIVE, BUT SAFE 1031 EXCHANGES:

Vacation Homes: Resort or 2nd homes (vacation homes) may qualify for favorable IRC 1031 tax exchange rules if your **"intent"** was to hold the property for "investment".

Reverse 1031 Exchanges: You may under IRS safe harbor rules, purchase a 1031 replacement property before selling your investment property.

Build or Rehab Improvement 1031 Exchanges: Investors can qualify for tax deferred treatment under IRC 1031 if they build a new property, or buy one and improve or rehab it.

Reverse Exchange With Rehab Improvement 1031: An investor can combine and use both the reverse 1031 and the rehab/improvement 1031 procedures to defer taxation. The investor would purchase the new property first, then rehab the property before selling his old property.


KEY: There are many types of tax-deferred methods of trading real estate to unlock your equity, and build wealth. "Timing" is key. Timing takes a little planning!

By: Richard Ivar Rydstrom, Esq.
Practicing California Attorney, Dean, Professor, J.D. Law, LL.M.
CALL 949-678-2218
rrydstrom@gmail.com
www.RydstromLaw.com

Richard Ivar Rydstrom, Esq. 949-678-2218 | RydstromLaw@Yahoo.Com