Capital Gains

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Lots of people are concerned about their liability for capital gains tax these days. Following is an informative perspective from Jennifer Pendizeck of Asset Preservation that may shed some light for you on this confusing subject:

"It is imperative to understand how you can avoid paying capital gain tax when selling any investment property. Currently, the federal long-term capital gain, which applies to assets held for a year or more, is at a lower rate than the short-term capital gain tax rate. The long term rate was reduced in 2003 to 15% for most taxpayers.

"The reduced tax rate is effective through 2010. Beginning January 1, 2011 the long term tax rate is scheduled to sunset and revert to the prior rate, which was generally 20%. Additionally, state income tax applies, and any depreciation taken over the years is recaptured at a federal rate as high as 25%.

"By performing a 1031 Exchange, you can defer all of the capital gain taxes due on the sale of a property. To fully defer the taxes, you must buy property or properties equal to or greater than the sales price of the one you are selling and spend all of the proceeds. If you buy for less, you can partially defer your taxes.

"Any taxpayer contemplating an exchange of a vacation home should be able to substantiate that their primary objective in owning the property is to hold it for investment, rather than personal use. Efforts to rent the property should be documented and rental income should be reported on their tax return.

"In an effort to make it easier to determine if your property would constitute an investment property Revenue Procedure 2008-16 has created a safe harbor for exchanges involving vacation properties , under which the IRS will not challenge whether a dwelling unit qualifies . The safe harbor will apply where: (1) the relinquished property is owned by the taxpayer for 24 months immediately prior to the exchange and the replacement property is owned for at least 24 months immediately after the exchange (the "qualifying use period"); and (2) within each of the two 12 month periods constituting the qualifying use period, the taxpayer has:

a) Rented the property to another person or persons at a fair market rent for 14 or more days; and

b) The taxpayer's personal use of the dwelling unit does not 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 market rent.

"Property that does not meet the terms of the safe harbor may also constitute qualifying investment property depending on the specific facts and circumstances. To be sure, any taxpayer contemplating a 1031 exchange should consult with their legal and tax-advisor."