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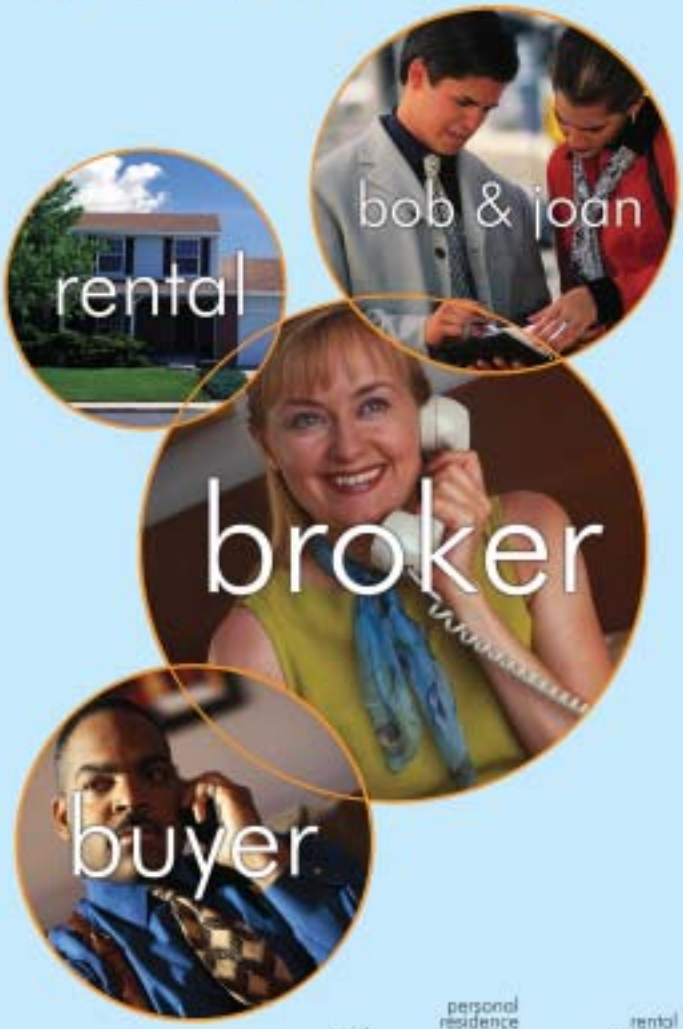
TAX-FREE EXCHANGES AND SALES OF RESIDENCES

BY JERROLD J. STERN



	total	personal residence portion	rental portion
land cost	$33,000	$16,500	$16,500
structure cost	220,000	110,000	110,000
total cost	253,000	126,500	126,500
depreciation on structure ($4,000 x 10 years)	40,000		40,000
tax basis at sale	213,000	126,500	86,500
sale price received	300,000	150,000 cash	150,000 rental property
gain on sale	$87,000	$23,500	$63,500
tax treatment of gain		excluded	postponed

When homeowners sell their homes, they typically avoid tax on the gain. When an investor trades one piece of investment real estate for another, tax is either postponed or avoided if all criteria for a tax-free, like-kind exchange are met. These results can be combined if an owner-investor lives in one unit of a duplex or other multifamily dwelling and rents out the other unit(s). Tax on the personal residence portion of the property can be avoided under the sale of principal residence rules, and the rental portion can be exchanged, with tax on the gain postponed or avoided under the like-kind exchange rules.

In the example (see table), Bob and Joan purchase a duplex for $253,000. The land value is $33,000, and the cost basis of the structure is $220,000. They live in one unit and rent out the other. For tax purposes, they have two separate assets — a principal residence and a rental property.

The rental half of the structure can be depreciated for tax purposes over 27.5 years using the straight-line method because it is residential rental property. Annual depreciation deductions are $4,000 (one-half of $220,000 divided by 27.5 years). Each year, the couple computes net rental income or loss by subtracting total rental property deductions ($4,000 depreciation plus operating expenses associated with the rental half of the property) from rent received.

Assume the property is worth $300,000 ten years later. Bob and Joan want to sell the personal residence portion for cash and trade the rental portion for another rental property without incurring taxes. They can accomplish this using a three-cornered exchange. A like-kind exchange intermediary (a broker specializing in three-cornered exchanges) finds a buyer who wants to purchase the duplex. The broker sells the duplex for $300,000 and then uses one-half of the cash to purchase a rental property chosen by Bob and Joan. The couple exchanges the duplex for the cash and rental property. All the sales contracts specify that the rental properties are being exchanged for each other, and the personal residence portion of the duplex is being exchanged for cash.

Under current tax law, as much as $500,000 of gain from the sale or exchange of a principal residence can be excluded by married taxpayers filing a joint tax return. Thus, the $23,500 gain from the sale of the residence portion of the duplex is excluded from income for tax purposes.

Gain from the exchange of the rental portion of the duplex, $63,500, is not taxed currently. Instead, the tax basis of the newly received rental property is set equal to the tax basis of the property exchanged, or $86,500. If the rental property is later sold for its $150,000 fair market value, the $63,500 "postponed gain" would then be recognized for tax purposes. However, if the value of the rental property declines over time, part or all of the postponed gain could escape income tax.

The like-kind exchange criteria must be met to secure tax-free treatment on the rental property exchange. The newly received rental property must be identified within 45 days and received within 180 days of the sale of the duplex.

The tax rules and computations for three-cornered exchanges are complex. Consultation with an accountant, attorney or real estate professional is recommended.

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