Facing a Huge Gain from a Realty Sale?

Article Highlights:

- Adjusted Basis
- Acquisition Value
- Passive Loss Carryovers
- Installment Sale
- Tax-Deferred Exchange
- Tax on Net Investment Income

If you are contemplating selling real-estate property, there are a number of issues that could impact the taxes that you might owe, and there are steps you can take to minimize the gain, defer the gain, or spread it over a number of years.

The first and possibly most important issue is adjusted basis. When computing the gain or loss from the sale of property, your gain or loss is measured from your adjusted basis in the property. Thus, your gain or loss would be the sales price minus the sales expenses and adjusted basis.

So what is adjusted basis? Determining adjusted basis can sometimes be complicated, but in a simplified overview, it is a dollar amount that starts with your acquisition value and is then adjusted up for improvements to the property, down for depreciation taken on the property, and down for any casualty losses claimed on the property. The acquisition value could be the price you paid for the property, the fair market value of an inheritance at the date of the decedent's death, or, in the case of a gift, the donor's adjusted basis at the time of making the gift.

As you can see, it is extremely important that you keep track of your basis, since it is a key factor in determining gain or loss upon the sale of the property. Failure to keep a record and substantiating documentation could cost you dearly in income tax.

If the property was a rental and the rental operated at a loss, there is a chance that the losses were not fully deductible in the year of the loss because of the passive loss limitation rules; in this case, you will have a passive loss carryover that can be used to offset the gain. In addition, passive loss carryovers you may have from other properties can also be used to offset any gain from selling a rental property.

Next, you have to decide whether you want to take (i.e., report on your tax return) all the income in one year or whether to attempt to spread the income over a period of years with an installment sale (by carrying back a loan) or defer the income into a replacement property through a tax-deferred exchange.

In an installment sale, the seller acts as the lender to the buyer. That can entail holding the first trust deed or taking back a second trust deed for only a portion of the loan amount. However, second trust deeds are as the name implies: They are second in line to be paid if the buyer defaults on the loan and thus are riskier. When set up as an installment sale, part of the gain is reported for each year that payments are received, generally as capital-gain income. In addition, the interest that the buyer pays the seller is taxable as ordinary income to the seller. Installment sales can be structured as short- or long-term loans, but remember, the buyer can always pay off the loan early or refinance. Either of these actions would make the balance of the profit from the sale taxable at that time.

Another option if the property is held for investment or used in a trade or business is to defer the gain down the road. This is accomplished by using the rules of IRS Code Section 1031, which allows the taxpayer to acquire like-kind property and defer the gain into the replacement property, which also must be used for business or be held for investment. However, the rules for like-kind exchanges are complicated, have strict timing issues, and require advance planning with a professional familiar with Section 1031 rules.

Adding complications to the sale-planning issue is the surtax on net investment income. This 3.8% additional tax kicks in when a taxpayer's modified adjusted gross income (MAGI) exceeds $200,000 ($250,000 for married joint filers and $125,000 for married individuals filing separately). Gain from the realty sale is included in the MAGI and could cause the MAGI threshold to be exceeded, resulting in this surtax applying to some or all of the realty gain. However, it may be minimized, or possibly eliminated, by using an installment sale and spreading the gain over a number of years or deferring down the road with a tax-deferred exchange.

If the real estate is your home (primary residence), there are special rules. Generally, if you own and occupy the home in two out of the five years prior to the sale, you will be able to exclude a substantial portion of your gain. The tax-deferred exchange rules do not apply to personal-residence sales.

As you can see, the result of selling real-estate property can include a number of tax issues, and minimizing current taxes requires some careful planning. Please give this office a call for assistance in planning your real-estate transactions.