Capital Gains Q&A

The subject of Capital Gains for Real Estate can be a difficult subject to understand. There can be many interpretations of tax rules. Equity Title has compiled several typical question and answers that might help you with the issue of Capital Gains.

Q. I lived in a home as my principal residence for the first 2 of the last 5 years. For the last 3 years, the home was a rental property before selling it. Can I still avoid the capital gains tax and, if so, how should I deal with the depreciation I took while it was rented out?

A. If, during the 5-year period ending on the date of sale, you owned the home for at least 2 years and lived in it as your main home for at least 2 years, you can exclude up to $250,000 of the gain ($500,000 on a joint return in most cases). However, you cannot exclude the portion of the gain equal to depreciation allowed or allowable for periods after May 6, 1997. This gain is reported on Form 4797. If you can show by adequate records or other evidence that the depreciation allowed was less than the amount allowable, the amount you cannot exclude is the amount allowed. Refer to Publication 523, Selling Your Main Home and Form 4797 (PDF), Sale of Business Property for specifics on calculating and reporting the amount of the eligible exclusion.

Q. Can you sell rental property and reinvest it into rental property without paying capital gains tax?

A. No. A deferred exchange will be treated as a sale rather than a tax-free exchange if the taxpayer actually or constructively receives money on other property in full consideration of the relinquished property. However, rental property may be exchanged directly for other rental property of like kind. Gain realized from such an exchange is deferred. For additional information on like-kind exchanges, refer to Publication 544, Sales and Other Dispositions of Assets.

Q. I have heard that I can sell my rental property and use the proceeds to purchase rental property of equal or greater value and the transaction is viewed just like an exchange in that the tax is deferred until the new property is sold. Is this true?

A. What you have heard about is a like-kind exchange. A like-kind exchange, when properly executed, represents a way to postpone the recognition (taxation) of gain essentially by shifting the basis of old property to new property. If, in addition to giving up like-kind property, you pay money in a like-kind exchange, you still have no recognized gain or loss. The basis of the property received is the basis of the property given up, increased by the money paid. There are several rules and restrictions that must be strictly adhered to in order for a successful exchange to take place. Deferred exchanges will be treated as a sale rather than an exchange to the extent that the taxpayer actually or constructively receives money or other (not like kind) property in exchange for the like-kind property given up. For more information refer to Publication 544, Sales and Other Disposition of Assets, and Form 8824 (PDF) Instructions, Like-Kind Exchanges.

Q. We sold a rental property last year and used the 1031 Tax Deferred Exchange law to defer the gain into another like-kind property. How do I report this transaction on my tax return?

A. Report the exchange of like-kind property on Form 8824 (PDF), Like-Kind Exchanges. The instructions for the form explain how to report the details of the exchange. Report the exchange even though no gain or loss is recognized. If you have any taxable gain, resulting from the transaction, because you had a partially deferred exchange or otherwise received money or unlike property, report it on Form 4797 (PDF), Sale of Business Property, and Form 1040, Schedule D (PDF), Capital Gains and Losses. Refer to Publication 544, Sales and Other Dispositions of Assets, which has a detailed section on qualifying like-kind exchanges.

Q. Can we move into our rental property, live there as our main home for two years, and sell it without having to pay capital gains tax?

A. You may be able to exclude your gain from the sale of your main home that you have also used for business or to produce rental income if you meet the ownership and use tests, detailed in Publication 523, Sale of Your Home. However, if you were entitled to take depreciation deductions because you used your home for business purposes or as rental property, you cannot exclude the part of your gain equal to any depreciation allowed or allowable as a deduction for periods after May 6, 1997. (Note: If you can show by adequate records or other evidence that the depreciation deduction allowed (did deduct) was less than the amount allowable (could have deducted), the amount you cannot exclude is the smaller of those two figures.) The gain, exclusion, and depreciation recapture should be reported on Form 1040, Schedule D (PDF), Capital Gains and Losses, as described in Publication 523, Selling Your Home.

Q. How long do I need to keep certain records?

A. Records such as receipts, canceled checks, and other documents that prove an item of income or a deduction appearing on your return should be kept at least until the statute of limitations expires for that return. Usually this is three years from the date the return was due or filed, or two years from the date the tax was paid, whichever is later. There is no period of limitations when a return is false or fraudulent or when no return is filed. You should keep some records indefinitely, such as property records, since you may need them to determine the basis of the property if it to prove the amount of gain or loss if the property is sold. For more details, refer to Publication 552 Record keeping for Individuals, or Tax Topic 305 on Record keeping. All references and publications, forms and tax topics can be found at the IRS website. www.irs.gov