HOW TO AVOID CAPITAL GAINS & LAND GAINS TAXES WHEN SELLING INVESTMENT REAL ESTATE IN VERMONT

by Christine Latulip

Anyone who has owned Vermont real estate for more than a few years is likely to have a relatively small tax basis compared to current fair market value, and thus faces potentially large state and federal capital gains taxes if they sell. Those selling a primary home they have lived in for more than two years have a great tax break available: the $250,000/$500,000 residential capital gain exclusions (explained in the article). Investment property does not qualify for this exclusion, but owners of such properties can take advantage of the increasingly popular "like-kind exchange" provisions of federal tax law to postpone, and in some cases, avoid entirely, both state and federal capital gains taxes (currently, the federal capital gains tax rate tops out at 15%, while the Vermont capital gains tax - which applies to the sale of real estate even if owned by a nonresident - ranges up to 5.7%, depending on income). Vacation homes that are rented out may qualify for such exchanges. In this article, Christine Latulip explains the details of like-kind exchanges. She is with Edmund and Wheeler, a Littleton, NH firm which has handled the paperwork for exchanges involving property in many states, including Vermont. Phone: 603-823-8888. E-mail: chris@section1031.com.

Under the provisions of Internal Revenue Code (IRC) Section 1031, tax deferred or "like-kind" exchanges of real property and certain types of personal property can be exchanged without immediate taxation. Any investment property or any property held for productive use, regardless of grade or quality, will qualify. This includes commercial property, improved or unimproved land, single-family homes, multi-family homes, and, under certain circumstances, vacation homes.
This means that you can use the provisions of Section 1031 to diversify or consolidate your real estate investment portfolio without incurring any federal capital gains tax or any Vermont capital gains tax; both are deferred, and this deferral can be almost completely eliminated with careful planning. Property owners with a low tax basis have the most to benefit from an exchange, since their tax obligation would be the greatest.

When you conduct a Section 1031 Exchange, you are in essence shifting your tax basis to the new property. If after exchanging your Vermont investment property for another investment property anywhere in the United States, you then sell the new property, the deferred gain from the sale of the original Vermont property will be taxable both by the federal government and by the state of Vermont. But there are a couple of situations in which you might not ever need to pay any tax.

One is to exchange your investment property - whether it is land, a commercial property, or a vacation home you treat as a business - for a property which at some point becomes your primary residence. If you own that new property for at least five years, and live in it as your primary residence for at least two years, you can sell it and avoid any tax on the first $250,000 in gains if you are single, and $500,000 if you are married. Tax would still be owned on any gain greater than that.

The second circumstance in which no capital gains tax will be due is if you die holding the new property. Under current law, your heirs will take possession of the property with a "stepped-up" basis and owe no taxes. (Note: the step-up in basis feature could eventually disappear if President Bush succeeds in permanently eliminating the estate tax.)

In sum, with a Section 1031 exchange, you can, at the least, postpone capital gains tax on the sale of your investment property, and in some circumstances, avoid some or all of the tax entirely.

Which properties qualify for a Section 1031 exchange when they are sold? As noted earlier, land held as an investment qualifies (if you have cut timber on the land that confirms its "investment" or "productive use" character). Commercial properties, such as office buildings, apartments and stores, qualify, as do single-family homes rented out to tenants who live there full time.

Whether a vacation home qualifies depends on the facts and circumstances. Vacation homes that are used exclusively for personal use do not qualify. Vacation homes that are never used by the owner and are only rented out to vacations, do qualify.

If a vacation home is both rented out to vacationers and used part of the time by the owner, it may or may not qualify. A good case can be made that it does qualify if the owners limit their personal usage to no more than and treat the property as a business, taking depreciation on their taxes and deducting other expenses such as advertising.

To treat a vacation home as investment property, federal tax law requires that the owner use the property personally for fewer than 15 days a year, or 10% of the days it is rented to others, whichever is greater (the owner may stay in the home for more days than that if on those days he or she is performing maintenance). Vacation homes that meet these conditions are considered investments and generally qualify for Section 1031 exchanges.

One important item to note for any properties that are depreciated is that through an exchange, the recapture of depreciation usually due when these properties are sold can be postponed, or in some cases avoided, in the same manner as capital gains are postponed or avoided.

Federal recapture of depreciation is taxed at up to 25%, while Vermont taxes recapture of depreciation at ordinary income tax rates, which range up to 9.5%.

If a vacation home has not been used in a way that qualifies it for Section 1031 - in other words, there has been too much personal use - it is possible to convert it to investment use, show rental income for a period of at least two tax years before selling, and qualify for an exchange.

Mixed-use properties that are partially residential and partly commercial can also qualify. This works well for property owners with a residence that sits on a lot of land that can be deemed "held for investment" and whose capital gain exceeds the $250,000/$500,000 residential exclusions.

For example, consider the owners of a primary residence situated on a farm property who are contemplating a sale of the entire property for $1.2 million. They have owned the property for a long time and have very low basis. They can use the personal residence exclusion of $500,000 and then allocate a large portion of the remaining sale proceeds to a Section 1031 exchange. This would allow for all of the gain in the property to be shielded from immediate taxation.

Specific rules apply to successfully use the provisions of 1031. In order to have your sale property qualify for deferred tax treatment, you must first employ the services of a "qualified intermediary" (QI) to handle your transaction (certain parties are prohibited from conducting this business, including your attorney or your accountant if they have performed services for you in the preceding two years). If you go to closing with a QI and receive the proceeds of the sale, it's too late; you've triggered the tax!

The task of the QI is to create an exchange agreement between itself and the client/taxpayer, have the contract of sale assigned to the QI, and instruct the settlement agent of the sold property to direct the net proceeds to its attention, to be held in escrow. The next step is for the taxpayer to identify its "replacement property" choices and negotiate agreements of purchase for those. Once purchase agreements are in hand, they are assigned to the QI, instructions are provided to the settlement agent and funding is arranged for the purchase of the new property using the escrowed funds.

All of this must be done within strict time periods. The law required that the client identify replacement property within 45 days of the day of the sale of the sold (or “relinquished”) property. Likewise, the entire transaction must be complete within 180 days of the sale of the first relinquished property.

To insure a good exchange in today’s real estate environment, it’s a good idea to have a contract of purchase already negotiated before you close on your existing property. If you fail to identify within the 45 days, the exchange fails and the sale is then subject to taxation.

When possible, the taxpayer should designate one or two backup properties in case the transfer of the first replacement property cannot be accomplished. While this technique will not lengthen the 45 day identification period for the primary or alternative properties, it will permit the taxpayer to complete the exchange with one of several properties, provided completion can occur within the replacement period deadline.

Withholding tax is assessed for the Vermont non-resident unless a waiver is sought prior to the sale from the Vermont Department of Taxes. In order to qualify, the taxpayer of investment property must provide evidence that it has entered into an agreement with a QI and intends to acquire like-kind property of an equal or greater value.

Vermont’s land gains tax may still be due if the property has been held for less than six years. However, if you exchange within the State of Vermont and identify and contract for the Vermont replacement property with thirty (30) days of the sale of the Vermont relinquished property (and the new property is equal to or greater in value than the old property) then the land gains tax is also deferred and the holding period for land gains tax purposes in the new property is the same as it was in the old property.

To achieve the best exchange, the purchase price of the new or replacement property must be of an equal or greater value than the price of the old or relinquished property. Otherwise, a taxpayer could owe federal and Vermont capital gains taxes on any difference in price.

Section 1031 is a specialized field and requires that you work hand-in-hand with your QI for the best result. In addition to the types of exchanges described here, there are also Reverse Exchanges, where you buy what you want before you have sold the existing property, Improvement Exchanges, and “build-to-suit” Exchanges. More information about Section 1031 like-kind exchanges is available on my firm’s website at www.section1031.com.

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