



SHIMONOV LAW

Tax-Saving Tips

June 2019

Combine Home Sale with the 1031 Exchange

You don't often get the opportunity to even consider making a tax-saving double play. But your personal residence combined with a desire for a rental property can provide just such an opportunity.

The tax-saving strategy is to combine the tax-avoidance advantage of the principal residence gain exclusion break with the tax-deferral advantage of a Section 1031 like-kind exchange. With proper planning, you can accomplish this tax-saving double play with full IRS approval.

The double play is available if you can arrange a property exchange that satisfies the requirements for both the principal residence gain exclusion break, and tax deferral under the Section 1031 like-kind exchange rules.

The kicker is that tax-deferred Section 1031 exchange treatment is allowed only when *both* the relinquished property (what you give up in the exchange) and the replacement property (what you acquire in the exchange) are used for business or investment purposes (think rental here).

Clarifying Example

Let's say your principal residence—owned for many years by you and your spouse—is worth \$3.3 million.

You convert it into a rental property, rent it out for two years, and then exchange it for a small apartment building worth \$3 million plus \$300,000 of cash boot paid to you to equalize the values in the exchange.

Your cost basis in the former residence is only \$400,000 at the time of the exchange. You realize a whopping \$2.9 million gain on the exchange: proceeds of \$3.3 million (apartment building worth \$3 million plus \$300,000 in cash) minus cost basis in the relinquished property of \$400,000.

Now, let's check on your tax bite. You can exclude \$500,000 of the \$2.9 million gain under the principal residence gain exclusion rules. So far, so good!

Because the relinquished property was investment property at the time of the exchange (due to the two-year rental period before the exchange), you can defer the remaining gain of \$2.4 million under the Section 1031 like-kind exchange rules. Nice! No taxes on this deal with proper tax planning.

Pay No Income Taxes Ever

If you hang on to the apartment building until you depart this planet, the deferred gain will be eliminated from federal income taxes thanks to the date-of-death basis step-up rule. Under the date-of-death rule, the tax code steps up the basis of the building to its fair market value as of the date of your death.

Example. You die. Your heirs inherit the building at its new stepped-up basis. They sell the building for its

date-of-death fair market value. Presto, no income taxes.

Of course, you do need to consider estate taxes if your estate is greater than \$11.4 million.

Know These Tax Rules If Your Average Rental Is Seven Days or Less

If you own a condominium, cottage, cabin, lake or beach home, ski lodge, or similar property that you rent for an “average” rental period of seven days or less for the year, you have a property with unique tax attributes.

Seven days example. Say you have a beach home and you rent it 15 times during the year, for a total of 85 days. Your average rental is 5.7 days. That’s an average of seven days or less for the year.

The right type of beach home or vacation cottage can produce great tax results when the average rental period is seven days or less. But it’s tricky because when the average rental period is seven days or less, the property is not a rental property as defined by the tax code. Instead, the property is a commercial hotel type property that you report on Schedule C of your tax return if you provide services in connection with the rentals, or a weird in-limbo property that you report on Schedule E when you don’t provide services.

If the property shows a loss, you can deduct that loss on either Schedule C or Schedule E if you can prove that you materially participate (i.e., manage the property). With the seven-days-or-less-average rental, you likely have only two ways to materially participate:

1. The combined participation by you and your spouse constitutes substantially all the participation in the seven-days-or-less-average rental activity when you consider all the

individuals who participated (including contractors).

2. The combined hours of participation by you and your spouse in the seven-days-or-less-average rental activity are (a) more than 100 hours and (b) more hours than the participation of any other individual.

Example. Your seven-days-or-less beach rental produces a \$20,000 tax loss for the year. On this rental, you spend 65 hours during the year. No other person works on the rental. You materially participate in this rental, and the \$20,000 is deductible—period (regardless of its location on Schedule C or E).

If you have a profit on the rental, you likely have a Section 199A deduction when you report the rental on Schedule C as a business. Although not deemed a business by Schedule E reporting, the Schedule E rental could rise to the level of a business as defined for the Section 199A deduction.

Can the IRS Require Odometer Readings with the Mileage Rate?

Do you claim your business miles at the IRS optional rate? If so, imagine you are now being audited by the IRS for your business mileage. The IRS has requested odometer readings for your vehicle. You might wonder if the IRS can do this.

The answer is yes. The tax code says that you must substantiate your business vehicle deductions by adequate records or by sufficient evidence corroborating your own statement, including the time and place of the travel and the business purpose.

The standard mileage rate does not reduce the need for vehicle mileage records. In other words, the need for the records that prove business mileage does not change when you use the IRS standard mileage rate.

They are the same mileage records you need with the actual expense method.

Here's what the IRS, in its *Internal Revenue Manual*, tells its examiners to do when looking at business miles:

To verify total miles for the year, the taxpayer should provide repair receipts, inspection slips or any other records showing total mileage at the beginning of the year as well as at the end of the year.

The bottom line here is that the burden of proof is on you to prove your business mileage as required by the law. Thus, make sure that you retain odometer readings at or near the beginning and end of the year from oil changes, vehicle inspections, and repairs.