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Trading places

By Julie Androshick

If you own a rental house that you'd like to sell, here's how to swap it for a home you can later move into—tax free.



R E A L E S T A T E

Call them "accidental landlords"—people who somehow end up living in one city but owning and renting out a house in another. This situation often arises when a job offer leads to a quick move with no time to sell a former house. And once you start renting out your old house—converting it from your primary residence to a business asset—you could lose the right to sell it without paying capital gains taxes on your profit. Unless you know how to play the tax code. Consider the story of Deborah and Paul McKeen, formerly of Tucson, Ariz. They departed a few years ago, but held on to a small house in Tucson and rented it out. Last year, tired of being absentee landlords and wanting to move closer to their families in New England, they decided to sell the Arizona house and apply the proceeds toward buying one in Maine.

They offered the house for \$123,000, or \$59,000 more than they had paid. Based on that price, they stood to owe \$20,000 in combined federal and state capital gains taxes. Then a real estate agent told the couple how they could unload the house in Tucson and put all the proceeds toward a house in Maine with no capital gains taxes due. The catch: They wouldn't be allowed to move into the Maine house right away but would have to rent it out for at least a year.

The strategy is called a Section 1031 exchange, in reference to the part of the Internal Revenue code that describes tax-free swaps of business property. Corporations use it to sell assets and replace them with other similar assets without paying capital gains tax. Individuals can use it, too.

In the simplest situation, two similar properties are swapped—your factory in Arizona for my factory in Maine. In real life, though, it's unlikely that anybody who wants to own the factory in Arizona also happens to want to unload one in Maine. So the courts permit a quick shuffle using an intermediary. You line up someone to sell you a property in Maine and someone else to buy the property in Arizona. The presence of the intermediary allows you to maintain the fiction that you aren't buying and selling, you're just swapping.

The middleman, called an exchange accommodator, might work for a specialist exchange company (often, a subsidiary of a title, escrow, accounting or law firm). You have 45 days from the sale of your old property to specify what you want to buy, then 180 days to buy it. You can't

touch the money in the meantime. To avoid tax, you must buy a new property worth at least as much as your old one.

Now, about that catch: Section 1031 was written to help businesses, not to let you sell your old residence tax-free and buy a new one. So you've got to act like a business. You must rent out your new house for at least 12 months and a day to bona fide tenants paying market-rate rent. But there's nothing to stop you from moving into your new house after that. You can even use a Section 1031 swap to buy your

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And here's the kicker: Once you've used the new house as your primary residence for more than two

years, you're eligible to sell it with the usual residential capital-gains tax exemption on up to \$500,000 of profit (\$250,000 for single people). That means you may never pay capital gains tax on profit from your original house (the one you swapped out of) or the new one.

There are around 200 exchange firms, though many real estate attorneys can handle the work as well. The McKeens, who ended up swapping for a \$150,000 house in Kittery, Me., used Professional Exchange Accommodators in Denver. To swap one home for another, expect to pay an exchange fee of \$500 to \$1,500, depending on the value and location of the properties.

Can you sell your house in 2016?

Economists, like meteorologists, can predict the distant future with remarkable accuracy when they focus on seasons. In 2010 February will surely be colder than August, and just as surely, there will be 20 million more middle-aged households than now.

What if they all retire to sunny climes and their homes in Greenwich, Conn., Boston and Seattle become a drug on the market?

"It's an interesting idea," says Nicolas Retsinas, director of Harvard's Joint Center for Housing Studies. "I'll be turning 65 in 2011, among the first of the baby boomers to do so. But what makes you so sure I'll want to leave? Our recent work shows that people like to stay in their homes as they age."

One sign, he says, is the steady, but less-than-explosive growth in assisted-care housing. Of course, many empty-nesters trade down, but that requires someone else who's trading up. Whom can we count on to take the torch from the biggest demographic bulge in U.S. history?

"First, immigrants," says David Berson, chief economist at Fannie Mae. "We've had more in the 1990s than in any other decade of the 20th century, and study after study has shown that after immigrants are here for ten years, their homeownership rates skyrocket. Then, ten years later, the children of baby boomers-the echo boom-will start buying, in some cases from their own parents."

If the numbers don't work out perfectly, the growing demand for second homes will paper over the cracks. Supply will also adapt. Last year there were 1.3 million starts on single-family homes, as compared with 68 million homeowners. If demand drops a little, construction will drop a lot.

So go ahead and buy that big, old house you crave.

--Philip E. Ross