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5 Ways Rich People Save Money on Real Estate Transactions

Andrew Lieb

1. **Closing Adjustments:** Sellers get repaid at the closing for all of their prepaid service contracts and supplies that they transfer to the purchasers. To do this, sellers identify each contract that they have prepaid for the carrying costs of their home. Next, sellers create a per diem cost allocation for each particular contract and multiply that cost by the days remaining on the contract on the closing date.

   > *Examples of contracts that sellers locate for adjustment purposes include:*
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   > - *Fuel contracts such as propane and oil*
   > - *Water contracts*
   > - *Real estate town and village taxes*
   > - *Condominium / cooperative common / maintenance charges*
   > - *Pool service contracts*
   > - *Tick and mosquito control contracts*
   > - *Gardening contracts*
   > - *Pest control contracts*

   Many also require the seller to order timely meter readings to determine the amount of the product, such as oil, that remains in the tank on the date of the closing. When all is said and done, a savvy seller recoups tens of thousands of dollars in prepayments if everything is documented and adjusted.

2. **IRC §121:** Capital gains tax is generally payable by a seller incident to the sale of a home. The top federal capital gains tax rate is 23.8%. However, homeowners who time their closing properly can avoid paying capital gains tax on the first 500,000 of gain realized at the sale from their original purchase price. Pursuant to the Internal Revenue Code's section 121, a married couple qualifies for this exemption if at least one of the two married spouses owned the home and they both used such home as their "principal residence for periods aggregating 2 years or more" over the 5 years preceding the sale date. If a seller cannot document 2 years of use, they must delay the closing accordingly. Further, a seller can only use this exemption one time every two years. In addition to the 23.8% capital gains tax, nonresident New Yorkers, estates, and trusts are liable for New York State estimated personal income tax and must withhold an additional 7.7% of the capital gain on the sale of their real estate that is located within the State pursuant to Tax Law section 663 (residents are taxed up to 7.7% on their state personal income tax returns as New York doesn't differentiate between capital gains and ordinary income). However, where property qualifies under the Internal Revenue Code's section 121 it is also exempt from this additional 7.7% withholding. To illustrate this savings, assuming a married couple, which is subject to the highest possible tax rate, doesn't utilize IRC §121 in a New York real estate sale, they will pay an additional 157,500 in taxes.

3. **IRC §1031:** Capital gains tax of up to 23.8% federally and another 7.7% in New York State is not subject to an exemption if the home was owned for other than a principal residence pursuant to section 121 of the Internal Revenue Code. However, section 1031 provides a means to defer the capital gains tax due for an indefinite period of time into the future and thereby compound one's real estate purchasing power by including that unpaid tax into the available purchasing monies for the next transactions. To utilize a 1031 exchange, a seller must both exchange real estate used for "trade or business or for investment" into like-kind property under strict timing rules and have the sales proceeds held by a qualified intermediary in between the first sales transaction and the subsequent purchases. In the simplest sense, the seller must buy new property within a half of a year of the first closing date.

   > *Yet, 1031 rules are quite cumbersome and have requirements for:*
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   > - *Deadlines to identify property*
   > - *The means of identifying a property*
   > - *The number of properties that can be identified*
   > - *The price of such property*

   Those with vacation homes also consider a 1031 exchange as the Internal Revenue Service offers a safe harbor to qualify such homes through rules embodied in Revenue Procedure 2008-16 regardless that such vacation homes were residences at some point in their history. A 1031 exchange enables a seller to generate income on future properties through compounding pre-tax dollars. Albert Einstein described this type of compounding effect with money as "the eighth wonder of the world."

4. **Step-Up-In-Basis:** If real estate is sold immediately after its owner's death, no capital gains tax is due by way of a concept called a step-up-in-basis. On the death of an owner of real estate, their beneficiaries are distributed such property at the date of death valuation for that real estate pursuant to the Internal Revenue Code's section 1014. Consequently, if the beneficiary immediately sells the property no capital gain is realized and no capital gains tax is due because the real estate's purchase price and its sales price will be deemed the same for tax purposes. Therefore, elderly and sickly owners of real estate, who purchased such real estate at very low comparative values to its present value, are ill advised to sell such property unless they are in real need of immediate money. Sometimes it is even prudent for the intended on-death beneficiaries to gift monies to the owner when they are in need of cash flow in order to avoid the necessity of such a sale.

   > *To illustrate this savings, while IRC §121 saves a maximum of 157,500 on a maximum gain of 500,000, there is no like maximum cap on a step-up-in-basis and every dollar of gain on top of the first 500,000 can receive a like savings.*

   So, assuming the real estate was purchased originally at 50,000 and it is now worth 4,000,000, and further assuming the decedent was in the highest possible tax bracket right before death, the family will save 1,260,000 in taxes by selling post-death.

5. **Mortgage Interest and Real Estate Tax Deductions:** It's true that if you make less money you pay less income tax. Yet, making less money is poor tax planning because the result is still that you have less money in your pocket and while you got the taxman you also hurt yourself. Instead, proper planning is to make a lot of money while limiting the amount of money that is taxable. Deductions from taxable gross income create this legal fiction (i.e., you make more real money than your taxable dollars). One of the best means to create this legal fiction is through deductions from income for the mortgage interest that you pay. Applicable to both first and second homes, deductions are itemized on Form 1040, U.S. Individual Income Tax Return, Schedule A. According to the IRS, "[u]sually, you can deduct the entire part of your payment that is for mortgage interest", except if your "total mortgage balance is more than1 million" or your mortgage wasn't taken "to buy, build, or improve your home." Like mortgage interest tax deductions, real estate taxes can also be deducted from your gross income for income tax purposes. To learn more, read IRS Publication 530. While tax deductions don't offer the same pop value in immediate money saved as compared with capital gains taxes, they are available year-over-year and those numbers truly add up over time.

Adapted from this Dan's Papers post.