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June 2001 - EARN THE MONEY TO PAY OFF YOUR HOME LOAN IN 10 YEARS . . . TAX FREE!

Tax law changes in 1997 made it perfectly legal to earn the money to pay off your home loan in about 10 years, tax free! This article will explain how to do it, and will also explain when you might want to consider selling your home to maximize the tax-free income that is available to you.

Using Your Own Labor to Earn a Paid Off Home

People have used the "sweat equity" concept for many years to help them get a home free of a mortgage in only about 10 years instead of the standard 30 years. They buy a "fixer upper" and do the needed improvements themselves to improve the value of the home. After living in it for a short time, they sell the home to convert the equity thus earned into cash. The cash is then used to purchase another "fixer upper" home, this time with a smaller mortgage. The process is repeated until the final home is bought totally for cash.

For example, suppose the first home is purchased for \$100,000 with zero down. After making improvements, the home is sold for \$120,000 after selling costs, and the owner now has \$20,000 cash plus the small monthly principal payments made on the mortgage. Since these principal payments are not significant to this illustration, they will be omitted from the remaining discussion. Next the owner buys another home, again for \$100,000, but this time with a \$20,000 down payment and an \$80,000 mortgage. After making improvements on this second home, it too is sold for \$120,000 after selling costs, and after the \$80,000 mortgage is paid, the owner has \$40,000 in cash. After a few repetitions (five, in this example) of this process, the owner has \$100,000 in cash and pays for a home without a mortgage.

This method can work just as well if you choose to buy a piece of land and build a home on it, then sell it at a profit and repeat the process. Of course, this takes more specialized skills and time, but for those who have those skills it can be an enjoyable and worthwhile process.

How the 1997 Tax Law Changes Make This Income Tax Free

Single people no longer have to pay either income or capital gains tax on the first \$250,000 of profit on the sale of their home, with the important restriction that it must have been their principal residence for at least two years during the five-year period ending on the date of sale. This will be referred to as the two-year test in the rest of this article. In my example in the previous section, after five repetitions of the home purchase, improvement, and sale process, the final home is owned free of debt. With a two year holding period for each home, the total period for five repetitions would be ten years, as referred to in the title of this article.

If the home is sold after one year, a federal capital gains tax of 10 to 20%, plus state tax, must be paid. If the home is sold before one year, full federal and state income taxes must be paid. This is a very powerful incentive to live in the home for two full years before selling! A married couple, filing jointly, follows the same rules but is allowed to exclude the first \$500,000 of profit on the sale of the home that has been the principal residence of both spouses for at least two years.

A prorated (smaller) exclusion is available for people who are forced to sell before meeting the two-year test because of a change in place of employment or health or "unforeseen circumstances" (as defined by the IRS).

Another benefit of these tax law changes is that you can repeat the same \$250,000 or \$500,000 exclusion on subsequent homes, by making each new home your principal residence for successive two-year periods. People who own homes that have appreciated enough to approach these limits may well want to consider selling the homes, cash in on the tax-free appreciation, and use the proceeds to buy a similar, but different home.

For example, if you can afford to purchase a home for \$400,000, and then as years pass you watch the value approach \$650,000 (if you are single) or \$900,000 (if you are married filing jointly), you could sell the first home without paying tax on the gain by meeting the two-year test. Then you could use the money earned to buy another \$900,000 home if you desire, and if that home later appreciates to \$1,400,000 the new \$500,000 gain would again be tax-free for a married couple filing jointly. This powerful planning tool would enable the couple in this example to enjoy a total of \$1,000,000 in tax-free appreciation on the sale of the two homes. If the couple stayed in the original home and it increased in value the same \$1,000,000, they would have to pay tax on \$500,000 of the gain, which would be \$100,000 in federal capital gains taxes, plus sizable state taxes, and the likelihood that other income earned in the year the home was ultimately sold would be taxed at higher rates than if the home was not sold. In fairness, it should also be noted that the tax on the appreciation could be avoided if the couple made certain never to sell the home either the husband's or the wife's lifetimes.

As with most tax topics, only the highlights can be presented in an article of reasonable length and readability. It is designed to increase awareness of tax planning opportunities that exist, but care should be taken to check the full details of your circumstances and the full scope of the tax law before acting on the suggestions given here. Professional help in doing so may be prudent.

If you have a tax or financial question you'd like to have answered in a future article, please contact me in care of the **Hurricane Valley Journal**. Next month's article will explore the subject "What Is Life Insurance – And Do I Need It?" I hope to have you with me again then.