

Is A Tax-Deferred Exchange Right For You? Basic Ground Rules

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Say you bought that waterfront lot five years ago for \$75,000 and your Realtor tells you it's now worth \$250,000. You'd like to sell it and put the proceeds into a rental house on the golf course, but you're not too excited about paying the capital gains tax of as much as \$26,000. A tax-deferred exchange (also referred to as a "like-kind exchange," a "1031 exchange," a "threeparty exchange," or a "Starker exchange") may provide a way for you to take that \$26,000, apply it to the rental house purchase, and delay the payment of the capital gains tax until you sell the new property.

Although the numbers and the properties differ, this is the type of question being faced by thousands of southwest Florida real estate investors during these last few years of escalating property values. It has become the rule, rather than the exception, that even casual real estate investors take advantage of the tax deferral benefits of Internal Revenue Code section 1031.

So what are some of the ground rules?

1. Both the property you sell and the property you buy must be held for investment purposes or for use in a trade or business. In the real estate context that means your principal residence, properties held in inventory, or properties acquired for the sole purpose of divestment, such as for a gift, cannot be any part of the exchange, whether its the property you're selling (the "relinquished property") or the property you're buying (the "replacement property").
2. So long as the properties in the exchange are held for investment purposes or for use in a trade or business, it doesn't matter how the properties are zoned or used. You can exchange a vacant beachfront lot for an apartment building or a gas station for a golf course.
3. You must set up the exchange prior to closing on the property you are selling. Once you've closed the deal and received the proceeds check, it is too late to unwind the "sale" and turn it into an "exchange."
4. There are two crucial deadlines you must be concerned with. First, starting with the closing date of the sale, you must identify your replacement property in writing to your qualified intermediary within 45 days. In addition, you are limited in the number or values of the properties you identify. Second, also starting with the closing date of the sale, you must close on the replacement property within 180 days. These rules are strict, and if you haven't done so, your exchange will fail and you will have to pay the capital gains tax.
5. You should make a rough estimate of how much tax you would have to pay on the sale of the relinquished property if you don't do an exchange. To do this on the sale of vacant

land or other property you have not taken any depreciation on, subtract the original purchase price and the cost of any capital improvements you've made on the property from the current sales price less any costs of the sale, such as broker's commission, doc stamps, and title insurance (but not subtracting any mortgage). Multiply the results by 15% if the property was held for more than a year.

6. If your tax liability is not that much, say less than \$5,000 to \$10,000, the extra cost of an exchange might not be worth the tax deferral. The "straight" or "forward" exchanges we've been discussing here will typically add between \$500 to \$1,500 to the cost of the transaction (multiple property exchanges are on the higher end of the range), and "reverse" exchanges or exchanges with construction implications (both beyond this article) may add \$2,500 to \$10,000 in costs.

7. The tax is not "saved," it is just "deferred." That is, the gain didn't just go away because you did an exchange. It's still built into the replacement property. And when you sell the replacement property, you'll have to pay the tax on that gain, unless you do another exchange, in which case the gain will be built into that new property.

8. Don't allow your aversion to pay tax cause you to make a bad real estate investment. If you decide you want your wealth invested in a more liquid asset than real estate, or if you can't find a replacement property at a reasonable price, consider taking your lumps and paying the tax. Don't lose the benefit of the tax deferral by paying that much or more over the fair market value of the replacement property.

Speak to your attorney or accountant about a tax-deferred exchange before you close on investment real property in which you have a significant profit. You may be able to take advantage of this increasingly common practice to have more money to invest into the next property you buy.