

Using Exchanges to Postpone Capital Gains Taxes

Benjamin Franklin is often credited with having said "In this world nothing is certain but death and taxes." For those of us who are invested in Real Estate, there are ways to defer the certainty of taxes and, coincidentally through death, avoid them totally!

As most of us know, our tax system is founded on the principle that whenever we realize a gain we should recognize that gain for tax purposes and therefore pay the tax. One of the only exceptions to that rule, for the real estate investor, is that if we reinvest by implementing a section 1031 exchange then the recognition is postponed. Over the years, many taxpayers have taken advantage of the exchange rules. With the elimination of favorable capital gains treatment (i.e. Tax Reform Act of 1986), more and more of us have been exchanging rather than pay taxes now at higher rates.

Although most of us are acquainted with Section 1034 of the Internal Revenue Code that allows us to delay the recognition of gain on the sale of our personal residence, some of us are unaware of Section 1031 which states that, "no gain...shall be recognized on the exchange of property held for productive use...or for investment if such property is exchanged solely for property of like kind which is to be held for productive use...or for investment."

In other words, if one plan on selling one's investment property and reinvest the proceeds in another investment property, it is most likely that one would be better off exchanging versus selling then buying. By better off, we mean that one might not have to pay any taxes on the gain that you realized in your original investment.

Financial Exchange Corp. (FEC) feels that the best way to understand what constitutes an exchange is to understand the definitions of the key words and phrases used in the statute and regulations. They are as follows:

Property held for productive use or for investment – Property transferred and property received must be held for productive use (example = rentals) or for investment (example = land) just before and just after the exchange. What this means is that one's intent is to hold onto the property for income or appreciation purposes. If one's intent is to sell (as a dealer) or to personally use (as a residence), the property would not qualify.

Like Kind - This refers to the type of property exchanged. Under this definition, one can exchange an apartment building for an apartment building; an apartment building for land; an apartment building for commercial or industrial property; or a leasehold interest for a fee interest (i.e. real property for real property). It is important to note here that in 1984 the IRS eliminated an interest in a partnership (general or limited) from qualifying as like kind. The IRS now appears to be discouraging accelerated depreciated real property verses longer term depreciated property exchanges as "like kind".

Solely Like Kind - Most often, if there is any tax to be paid at the end of an exchange, it is because of boot received. Boot is anything of value received that is non-like kind to the property given. The most notable culprit is cash. Other forms of boot are mortgage relief and seller carry back financing. The main cause for the generation of boot is differences in equity. Very rarely will you be able transact an exchange where the fair market value and debt on the property transferred ("down-leg") and property received ("up-leg") are identical

Exchange - To qualify for the tax deferral, there must be an exchange (i.e. a swap; a transfer of property for other property). This exchange can occur simultaneously in many forms. Some simultaneous exchanges take place with one property being exchanged by one person for one property by another. Some simultaneous exchanges take place with multiple properties being exchanged by many people (i.e. "pot" escrow). The common denominator in simultaneous exchanges is that the recording (i.e. the close of escrow) for both the property transferred and the property received, is on the same date. Up until 1979, all exchanges had to be simultaneous to qualify for tax deferral.

Delayed Exchange - Ever since the landmark Starker case in the late 1970s, taxpayers have taken advantage of the fact that they can complete the "sale" of their current holding before starting to look for replacement property. The IRS and subsequently Congress felt that the liberal Starker exchange was prone to abuse, so in the 1984 Act, the "45 days to identify/180 days to complete" rule was introduced. Needless to say, the IRS was still uncomfortable after seeing the varied implementations. In 1991, in an effort to restrict the many alternative interpretations that were being implemented, the IRS decided to spell out a safe harbor. Remember a safe harbor implies that if you follow the rules, your exchange will not be challenged! The following is a brief review of delayed exchange terminology and the safe harbor regulation

Accommodator: If you are contemplating a delayed exchange, then you will most likely require an accommodator to act as an intermediary for your exchange. You see, even though you are allowed to take up to six months from transaction to transaction, to qualify for the tax deferral you are forbidden from ever having access to the proceeds from the sale before it is reinvested. By using this third party, who will be responsible for holding the proceeds from the sale (i.e. your equity), you will avoid being judged to have been in constructive receipt of the money.

Qualified Intermediary: The regulations go about defining who may and who may not act as the taxpayer's intermediary (i.e. accommodator). The bottom line is that anyone who is considered to be related to the taxpayer or as acting as the taxpayer's agent is not qualified! That means that your attorney, your broker and/or your accountant are not viable intermediaries as long as they can be construed to be acting as your agent!

45 days/180 days: In a delayed exchange, Section 1031 (a)(3) provides for certain deadlines. First, the property received in the exchange must be identified by the transferor on or before the 45th day after the close of the transfer escrow. Second, the completion of the exchange must occur within 180 days after the close of the transfer escrow or before the due date of the transferor's tax return (including extensions) for the year in which the transfer occurred, whichever is sooner. Be careful not to file your return before the exchange is completed!

Written identification: The replacement property(s) must be identified in writing and the identification document must be dated and delivered to the intermediary within the 45 days.

Three properties-or-200 percent rule: As to the question of how many replacement properties the taxpayer may identify? The regulations clearly state that the taxpayer may identify no more than three properties of unrestricted fair market value or any number of properties whose collective fair market value is equal to or less than 200 percent of the relinquished property's fair market value. Any property acquired during the 45 days is by definition identified!

Constructed property: The taxpayer may exchange into "build to suit" property (i.e. under construction) as long as the completed property is suitably identified. Should the 180 days elapse before total completion of property, then a percent completion factor will be used in establishing the value of the exchange property. Any unfinished construction at that time will be "boot".

Growth factor: As you know, the money held by the accommodator could be significant (i.e. hundreds of thousands of dollars) and could be there for up to six months. Even at CD interest rates, that can amount to a lot of money. This return on moneys held is what is referred to as the growth factor. The regulations state that it is okay for the intermediary to credit interest earned on the money held to the taxpayer's account!

Reverse Starker - On occasion, you might run into the problem of needing to close the purchase escrow on the replacement property ("up-leg") before you can sell your property ("down-leg"). Unlike a personal residence (Section 1034), you do not get to do it in Section 1031. To accomplish this and still qualify for an exchange you can execute a reverse Starker. You can hire an accomodator to purchase the replacement property and then exchange with him at the close of your sale escrow. By now I hope you have a reasonable feel for tax deferred exchanges. I also hope that you have realized that there are many issues to be reckoned with prior to initiating and during the exchange. When it comes to Section 1031, the IRS and the Tax Courts repeatedly argue that it is very important for the "substance" and the "form" of the law to be followed. FEC encourages one to consult with an escrow officer, tax advisor, as well as one's attorney prior to and during the exchange to ensure a successful transaction.

FEC recommends experienced professionals that have the knowledge and expertise to help you understand and implement a tax-deferred exchange. We invite you to contact us with regard to your specific needs.