

Tax Deferred Exchange Gives Flexibility To Investors

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from the Atlanta Journal-Constitution HomeFinder

In our short series on tax breaks for real estate owners, we have talked about benefits for homeowners and we've covered loopholes for investors. This week, we'll examine the so-called "tax-free" exchange and see why it is becoming so popular.

In a nutshell, an exchange allows the investor to sell one property, replace it with another, and pay no taxes on the transaction. This can be extremely helpful in both moving your investments physically and in replacing one type of investment with another.

Now, here are the details:

1. Section 1031 of the IRS code says that only investment property or property held for trade or business can qualify for a tax-deferred exchange.

Generally speaking, investment property is any real estate that you purchase for the purpose of a long-term hold. In contrast, if you buy a house for the purpose of fixing it up and selling it for a profit, the IRS calls that "inventory" and that house would not qualify for an exchange.

But if you rented that house to a tenant for a year or two, the IRS will likely view your house as an investment, and an exchange would be allowed.

2. As an investor owns a rental property for a number of years, it builds a potential tax liability in two areas: appreciation and depreciation. The increase in value is the appreciation, and it is typically taxed at 15% federal plus 6% in Georgia. In addition, any allowable depreciation deductions accruing over the years of ownership must be "recaptured" - in other words, the entire dollar amount of allowable depreciation over the years is taxed at 25%.

These two levels of tax can add up fast, especially if you have owned a rental house for a number of years, and the tax bill can sometimes exceed the amount of proceeds available to the seller. An exchange can help avoid some or all of that tax liability.

3. A properly planned exchange allows the investor to sell his "old" investment for the best price he can get, then purchase one or more "replacement" properties and pay no tax on the transaction. The property must be "like-kind," meaning that all the replacement property must be held for investment, not used personally.

So you might exchange a rental house for three smaller rental houses, or you could exchange an apartment building for a gas station and ten

acres of land. You can also use an exchange to physically relocate your investments.

For example, if you had lived in Atlanta for many years and owned several rental houses, you might decide to retire (or relocate) to St. Simons Island. If you sold all your rentals in Atlanta, the tax bill might be enormous. But if you could exchange into several rental condos on Saint Simons, you would potentially owe no tax whatsoever.

4. In order for an exchange to be totally tax-deferred, the seller must "spend the cash and replace the debt." In other words, if cash is received on the sale of your "old" properties, you must spend it all (or more) on your replacement properties. In addition, if you were relieved of any debt when you sold, you must make sure the replacement properties have an equal or greater level of debt on them when you purchase.

5. In addition to the monetary rules, there are rigid time frames imposed by the tax code. From the day you sell your old property, you have exactly 45 days to identify your replacement property or properties. There are specific rules governing this identification procedure. Furthermore, from the day you sell your old property, you have up to 180 days to purchase the replacement. Failing either of these "bright line" tests will cause your exchange to be disallowed.

6. Because of the complexity of this type of transaction, it should be planned carefully by the investor with the help of a "qualified intermediary," who specializes in exchange transactions. The intermediary cannot be anyone who has provided you professional services in the past, so your attorney and your accountant are immediately disqualified.

Instead, there are firms which do nothing else but provide these services, and they are relatively inexpensive. For example, one critical rule is that the seller must not receive or have access to the proceeds of sale from the old property. On your behalf, the intermediary receives and holds these proceeds, and uses the money to pay for the purchase of your replacement property. And they make sure you are following all the rules and regulations for a successful tax-deferred exchange.

If you've gotten this far, you are likely beginning to feel the burden of the IRS rules on this procedure. That's because the IRS would prefer that investors simply pay the taxes on each transaction as they occur, rather than use this procedure to postpone the day of tax reckoning.

But the great advantage for investors is this: by performing an exchange instead of a normal "sale & purchase," the investor can postpone paying literally tens of thousands of dollars in tax, and perhaps much more. The tax liability from the relinquished property moves forward into the replacement property, waiting for the day when the investor finally and forever decides to sell.

Thus, in an properly structured exchange, the investor manages to keep all his money at work, rather than allowing significant sums to be siphoned off at each sale date.

As always, talk to your CPA or tax attorney for details on this complex transaction. For a more in-depth discussion of exchanges, visit my website at money99.com. The expanded version will be posted Sunday morning.

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