

Tax Deferred Exchange

Suppose you own a rental house investment property in which you have accrued \$100,000 equity from appreciation in market value and gradual pay-down of your mortgage balance. You would like to use that \$100,000 to acquire more investment properties. However, if you sell, you will owe capital gains tax.

You ask if there is any way to use that \$100,000 equity to buy more properties without paying tax on your sale profit?

The answer is "yes." It's called a tax-deferred exchange, authorized by Internal Revenue Code 1031.

WHAT IS A TAX-DEFERRED EXCHANGE? To qualify for a tax-deferred exchange, a real estate investor must trade "equal or up" in both price and equity for one or more qualifying "like kind" properties without taking out any taxable "boot," such as cash or net mortgage relief.

But "like kind" property does not mean "same kind." To illustrate, you can trade a rental house for an apartment building, or a warehouse can be traded for an office building. You can even trade your vacant investment land for a shopping center.

Just about any real estate held for investment or for use in a trade or business is eligible. However, your personal residence and "dealer property," such as a home builder's inventory of houses cannot qualify.

For example, my first tax-deferred exchange was a trade of my three-unit apartment building for a nine-unit apartment house. I traded equal or up in both price and equity without receiving any taxable "boot" cash or net mortgage relief.

However, the owner of the nine units was the "down trader." He received taxable cash when he sold my three-units to a cash buyer who was waiting to purchase it after my tax-deferred exchange was completed.

WHY TRADE INSTEAD OF SELLING? Since 1921, Internal Revenue Code 1031 has encouraged investment and business property owners to trade their properties to avoid paying capital gains tax. Taxwise, a qualified tax-deferred exchange is viewed as one continuous investment.

There are at least eight basic reasons for tax-deferred exchanges: (1) pyramid your equity tax-deferred without paying capital gains tax; (2) get rid of a property that is hard to sell by trading for one that is more easily marketable; (3) eliminate or minimize the need for new financing on the acquired property; (4) acquire a property which is easier to manage; (5) defer part of your profit tax by trading down and taking back an installment sale mortgage; (6) acquire a property with greater profit potential, such as a "fixer-upper"; (7) receive tax-free refinance cash either before or after the exchange (but not as part of the trade); and (8) accept an unsolicited profitable purchase offer to sell your investment without paying capital gains tax.

STARKER EXCHANGES SIMPLIFY TAX-DEFERRED EXCHANGES. Although my first tax-deferred exchange was a simultaneous "up trade" of one "like kind" property for another, it is no longer necessary to make a direct trade. In 1979, T.J. Starker won his famous U.S. Court of Appeal decision (602 Fed.2d 1341), which approved "delayed" tax-deferred exchanges.

Starker sold his Oregon timberland to Crown-Zellerbach Corp., which then held his sales proceeds until he located suitable replacement property to purchase with that money. However, upon audit, the IRS argued that was a taxable sale. Starker paid the disputed tax and then sued for a refund. Fortunately for investors, Starker won.

The result is Internal Revenue Code 1031(a)(3), which authorizes indirect delayed tax-deferred exchanges. Starker exchanges have now become the most popular type of tax-deferred exchange.

TIME LIMITS APPLY TO STARKER EXCHANGES. To qualify for a Starker delayed tax-deferred exchange, the sales proceeds for the investment or business property must be held in trust beyond the trader's "constructive receipt" by a qualified third-party intermediary.

Most title insurance and bank trust departments can now handle Starker exchanges. After the sale of the old investment property, the trader has 45 days to designate the qualifying replacement property to be purchased with the sales proceeds. IRS regulations permit up to three possible property acquisitions to be named. The up-trader then has 180 days from the sale date to complete the acquisition.

I.R.S. LEGALIZES REVERSE EXCHANGES. In 2000, the IRS issued Revenue Procedure 2000-37, which approved "reverse exchanges." The result is a qualifying replacement property can now be acquired before the old exchange property is sold.

A reverse exchange overcomes the short 45-day Starker replacement property designation time limit by permitting acquisition of the replacement property before the old property is sold.

However, title to the reverse exchange replacement property must be taken in the name of the third-party intermediary until the up-trader's old investment or business property is sold.

TRADE FOR YOUR ULTIMATE DREAM HOME BY SELLING YOUR INVESTMENT PROPERTY WITHOUT OWING CAPITAL GAIN TAX. Is your investment property goal is to sell your rental or business property and use the sales proceeds, without owing capital gains tax, to acquire your ultimate dream home?

Because your personal residence is not allowed in a tax-deferred exchange (all exchange properties must be "like kind" held for investment or use in a trade or business), several steps are required to accomplish your dream home goal.

Suppose you own a commercial building where you have a large equity. Your goal is to trade for a lavish home where you can spend your retirement years. However, if you trade for a personal residence, your exchange won't qualify for tax-deferral because you will have an "unlike kind" trade.

But with careful tax planning and a Starker exchange, your dream can come true. The first step is to sell the commercial building and have the sales proceeds held by a qualified third-party exchange intermediary beyond your constructive receipt.

The second step is to instruct your intermediary to use the sales proceeds to acquire the ultimate dream house you designate. However, don't move in.

The third step is to rent that house to tenants so it can qualify for the tax-deferred exchange. After a year or so, move the tenants out and convert the rental house into your personal residence without owing any capital gain tax.

If you still own your dream home when you die, you will have accomplished the ultimate tax shelter. The reason is any capital gain tax that would be due if you sold that dream house before you die is forgiven upon your death. To make tax matters even better, your heir will receive a new "stepped-up basis" to market value at the date of your death.