

## **Exchange your way to real estate wealth**

### **'Up trading' to larger fixer-upper invites profit potential**

Suppose you own a rental house or condo, apartment building, commercial property, warehouse, office building or even vacant land, which is now worth much more than you paid for it years ago. You've also probably been enjoying non-cash depreciation tax deductions for estimated wear, tear and obsolescence, thus reducing your adjusted cost basis (and your annual income taxes). However, if you sell, you'll owe a large capital gain tax. Is there any way to avoid tax on the sale of an investment property? Thankfully, the answer is "yes."

**TAX-DEFERRED EXCHANGES FOR 'MOM AND POP' AS WELL AS BIG CORPORATIONS.** Millions of "mom and pop" U.S. realty investors have discovered Internal Revenue Code §1031 tax-deferred exchanges. This is the only tax-free way to pyramid your real estate wealth without owing taxes along the way. Many realty fortunes have been built using this technique. Even major corporations use tax-deferred real estate exchanges.

**EXAMPLE:** Several years ago I had lunch with a realty agent for what is now Texaco-Chevron. He explained that his company had received a very profitable offer to sell its gas station land across the street from Disneyland. Rather than pay tax on their huge profit, his employer was making a tax-deferred exchange of that gas station for several other properties.

**WHAT IS A TAX-DEFERRED REALTY EXCHANGE?** Summarized, a tax-deferred exchange means a realty investor trades "equal or up" in both price and equity for one or more qualifying properties without receiving any taxable "boot," such as cash or net mortgage relief. Virtually any investment or business real estate, except your personal residence or "dealer property," such as a homebuilder's inventory, can qualify.

I will always remember my first tax-deferred exchange. It was a trade of my three-unit apartment building for a nine-unit apartment building. However, the seller of the nine units didn't want to keep my little three units. He wanted cash! So the Realtor arranged for a "stand-by buyer" to purchase my three units the next minute after I completed my tax-deferred exchange up.

Everyone (except perhaps Uncle Sam) was happy. I got my tax-deferred "up-trade" of three units for nine rental units. The seller of the nine apartments got the cash he wanted (on which he paid capital gains tax because he made a taxable trade down). Equally important to me, I acquired a "fixer-upper" nine-unit apartment building with profit potential after I fixed it up.

**WHY EXCHANGE INSTEAD OF SELL?** Since 1921, Internal Revenue Code §1031 has encouraged investment and business property owners to exchange their properties without owing any capital gain tax. The IRS views an IRC §1031 trade as one continuous investment even though two or more properties are involved.

The basic idea is to dispose of a qualified property (such as my three units) and acquire a "like kind" replacement of equal or greater cost (such as the nine apartments) without receiving any taxable "boot." But "like kind" real estate doesn't mean "same kind." To illustrate, you can trade your rental house for an office building. Or you can swap vacant land for a warehouse. You might even exchange your three rental cottages for a mobile home park. The number of properties on each side of the trade doesn't matter. Just remember to trade equal or up in both price and equities without taking anything out of the swap, such as cash or mortgage relief.