

# GAINS RATE RISING

## Section 1031 Exchange Basics

*R. Kymn Harp*

Before you follow the suggestion being made by some investors and advisors that you should sell your appreciated real estate now, before the capital gains rate goes up under President-elect Barack Obama's administration, you may want to read this article.

Besides the fact that a rising capital gains rate isn't the only tax burden you must consider when selling real estate, you may want to ask yourself why you *ever* want to pay *any* capital gains tax on the sale of your commercial or industrial real estate. You don't have to if you intend to continue investing in real estate and are willing to think ahead to plan your transaction appropriately .

I'm not talking about some exotic tax shelter scheme. I'm talking about taking advantage of an express provision of the Internal Revenue Code. I'm talking about using a transaction structure that has been around for over eighty years and that has been recognized and approved by tax courts and the Internal Revenue Service. I'm talking about taking advantage of Section 1031 of the Internal Revenue Code.

I know, talking about the Internal Revenue Code may sound boring or even intimidating, but this is something you need to know as a real estate investor.

What if I framed the issue another way?

What if I told you that you could get a hefty 0% interest loan from the federal government to invest in commercial or industrial real estate? Would you be interested?

Better yet, what if that loan has no fixed monthly, quarterly, or annual repayment obligations and does not show up on your credit report or balance sheet as an outstanding liability?

Still better yet, what if the terms of the loan provide that it may never have to be repaid? Are you interested now?

In effect,\* that's what a Section 1031 exchange can do for you. Here's how:

Section 1031 of the Internal Revenue Code permits a taxpayer to dispose of property used in its trade or business or held for investment purposes without paying federal income taxes, including capital gains taxes, on any gain arising from the transaction. To qualify for nonrecognition of gain, the taxpayer disposing of the qualifying property must comply with the technical requirements of Section 1031 by exchanging the property for other like-kind property within the time period provided by the statute. In general, that time period is 180 days but may be cut short if the taxpayer files its tax return for the period in which the Section 1031 exchange was initiated

*\*Apologies to my conservative friends who will point out that tax relief is not a governmental loan, but rather a non-taking of the taxpayer's own money.*

before the 180-day period expires. The key Section 1031 exchange rules are outlined later in this article.

To demonstrate the value of a Section 1031 exchange, I want to focus on the concept that a Section 1031 exchange permits you to dispose of qualifying property without being obligated to pay federal income taxes on any gain arising from the transaction. It works like this:

Scenario number 1. Suppose you bought a parcel of vacant ground for \$100,000, with the intent to use the parcel in your trade or business or simply to hold for investment purposes. A few years later, you decide to sell the parcel, which has risen in value to \$300,000. Upon sale, you will have a taxable gain of \$200,000.

Assume a federal capital gains tax rate of 15%. This is the current rate under the present tax code, although President-elect Barack Obama has indicated that he may seek to increase the capital gains tax rate to 25%. Such an increase will make use of a Section 1031 exchange even more valuable. Even if no changes are made to the current tax code, the capital gains rate is scheduled to increase to 20% on January 1, 2011. (There may also be applicable state taxes that can be deferred.)

At a 15% capital gains rate, the federal income tax payable in scenario number 1 is \$30,000 ( $15\% \times \$200,000 = \$30,000$ ). If you held the property free and clear with no mortgage, you would be left with \$270,000, which could be used to acquire another property ( $\$300,000$  sale price -  $\$30,000$  capital gains tax =  $\$270,000$ ). As the tax rate on capital gains increases, the amount remaining after taxes for reinvestment decreases. For instance, if the capital gains tax rate is increased to 25%, the tax on the \$200,000 gain would increase to \$50,000, leaving you only \$250,000 available to reinvest Scenario number 2.

Suppose instead of purchasing a parcel of vacant property, as assumed in scenario number 1, you bought a parcel of improved real estate. Suppose the purchase price was \$500,000, with \$100,000 allocated to the land and \$400,000 allocated to building improvements. Ten years later, you sell the property for \$700,000. During the ten-year period you owned the property, you deducted \$100,000 as depreciation expense.

Although the property is sold for \$200,000 more than your purchase price, the gain you realize is actually \$300,000 because the \$100,000 accumulated depreciation deduction reduces the property's tax basis by a corresponding amount. As a consequence, although you purchased the property for \$500,000, the current tax basis (after depreciation) is only \$400,000. Therefore, the taxable gain is \$300,000, calculated by deducting the tax basis from the sale price.

At first glance, you may believe that the effect of the foregoing is to increase your capital gain to \$300,000 resulting in a tax of \$45,000 ( $15\% \times \$300,000 = \$45,000$ ); but that is not correct. Under current tax law, you are required to first pay a tax on an amount equal to the accumulated depreciation taken as a deduction on the property, at a depreciation recapture tax rate of 25%, with the balance of the gain taxed at the assumed 15% capital gains rate. As a consequence, the

tax you will owe is \$55,000 (25% x \$100,000 depreciation recapture = \$25,000, plus 15% x \$200,000 capital gain = \$30,000, for a total tax of \$55,000). If we once again assume for simplicity that you did not have a mortgage on the property, you would be left with \$645,000 to reinvest in another property.

The beauty of a Section 1031 exchange of like-kind property is that the gain on the transactions described in scenario number 1 and scenario number 2 is not recognized at the time of sale, with the result that you do not have to pay either capital gains tax or depreciation recapture taxes on the transaction. Consequently, in scenario number 1, you will have the whole \$300,000 to reinvest; and in scenario number 2, you will have the whole \$700,000 to reinvest.

The capital gains taxes and the depreciation recapture taxes are not waived by use of a Section 1031 exchange, but rather, the obligation to pay these taxes is deferred until a future transaction that results in a taxable event that recognizes a gain. Since there is no prohibition against utilizing the Section 1031 exchange procedure in successive transactions, payment of taxes on the gain can be deferred indefinitely. If the taxpayer is a limited liability company, corporation, trust, or other entity with a perpetual existence, the day of reckoning for payment of the capital gains taxes and depreciation recapture taxes may never come. You will, however, limit your depreciation deduction because the tax basis of the relinquished property will carry over as the tax basis of the replacement property. This tax basis can be adjusted upward if additional capital is contributed to acquire the replacement property or, thereafter, to improve the replacement property.

If the taxpayer/Exchangor is a natural person rather than a limited liability company, corporation, trust, or other independent legal entity, the Internal Revenue Code provides that upon the death of the taxpayer/Exchangor, the tax basis of all property owned by the taxpayer is stepped up to the property's fair market value as of the date of death. As a consequence, no capital gains tax or depreciation recapture taxes will ever be recognized on the prior exchanges.

It is these attributes that form the basis of my statement at the outset of this article that it is possible to, in effect, obtain a long-term loan from the federal government, without interest, without scheduled periodic payments, without reflecting an outstanding liability on your credit report or balance sheet, and, possibly, with no obligation to ever repay. It is not a perfect analogy, but you get the point.

There are a whole host of technical rules that apply to Section 1031 exchanges. For this reason, advice from a knowledgeable tax advisor is critical when structuring a Section 1031 exchange.

As the sub-title of this article suggests, it is intended to give you only the basics. The purpose of this article is to alert you to the potential value and benefit of structuring your sale transaction as a Section 1031 exchange.

The following is an outline of key rules applicable to Section 1031 exchanges. Become familiar with these rules. Unless you intend to completely cash out of real estate investing, a Section 1031

exchange may work to your benefit. If you intend to keep investing in real estate or using real estate in your trade or business, a Section 1031 exchange will maximize the capital you have available to reinvest.

### ***Key Elements of a Section 1031 Exchange***

What is Section 1031?	Section 1031 refers to Section 1031 of the Internal Revenue Code.
What does it do?	Section 1031 permits a taxpayer (the Exchangor) to dispose of certain real estate and personal property and replace it with like-kind property without being required to pay taxes on the transaction.
What property qualifies?	To qualify for a Section 1031 exchange, the property being disposed of (the Relinquished Property) must have been used in the Exchangor's trade or business and/or must have been held for investment purposes. The property being acquired (the Replacement Property) must likewise be acquired for use in the Exchangor's trade or business or for investment.
What property is considered like-kind?	<p>To be like-kind means simply that real estate must be exchanged for real estate, and personal property must be exchanged for personal property. Personal property is any property that is not real estate.</p> <p>For example, a warehouse may be exchanged for another warehouse or for any other qualifying real estate including, for instance, a factory building, office building, shopping center, single-tenant store, parking garage, or even a parcel of vacant ground so long as it qualifies as being acquired for use in the Exchangor's trade or business or is to be held for investment. This is not a difficult test to pass. Similarly, a qualifying parcel of vacant ground or a shopping center or office building or factory or other parcels of investment real estate may be</p>

exchanged for any other qualifying real estate investment.

Similarly, subject to certain exclusions, qualifying equipment and other personal property used in a trade or business or held for investment purposes may be exchanged for other qualifying equipment or personal property for use in a trade or business or to be held for investment purposes.

What property is excluded?

The following types of property do not qualify for a Section 1031 exchange: stocks, bonds, partnership interests, limited liability company interests, personal residences, and stocks in trade or inventory.

Are there timing issues?

Section 1031 exchanges can be simultaneous, but they are not required to be. In fact, most exchanges made pursuant to Section 1031 are not simultaneous. There are, however, strict timing rules that apply to nonsimultaneous exchanges and strict rules prohibiting access to funds.

What are the time limits?

The Replacement Property or properties must be identified, in writing, not later than forty-five days after the Relinquished Property is transferred (the Identification Period). The Replacement Property or properties must be acquired not later than the earlier of (i) 180 days after the Relinquished Property was transferred, or (ii) the due date for the Exchangor's tax return, including any extensions (the Acquisition Period). The Identification Period is included within the Acquisition Period.

How many Replacement Properties may be identified?

There is no fixed limit to the number of Replacement Properties that may be identified, but there are three rules that apply: (1) the Three-Property Rule, (2) the 200% Rule, and (3) the 95% Rule.

1. The Three-Property Rule allows you to identify up to three (3) properties as potential Replacement Properties, regardless

of value. You need not acquire all three properties, but as of the end of the Identification Period, not more than three properties may be identified. This is the most commonly used identification rule.

2. The 200% Rule allows you to identify any number of potential Replacement Properties so long as the aggregate value of all identified properties does not exceed 200% of the value of the Relinquished Property. You need not acquire all identified properties.
3. The 95% Rule allows you to identify any number of potential Replacement Properties, regardless of value so long as you actually acquire within the Acquisition Period at least 95% of the value of all properties identified.

Must all exchange proceeds be used?

There is no requirement that all proceeds received upon sale of the Relinquished Property be used to acquire the Replacement Property. Any exchange proceeds not used, however, are taxable.

What constitutes exchange proceeds?

Exchange proceeds means the net sale price of the Relinquished Property, including all net equity and the amount of any mortgage encumbering the Relinquished Property, whether paid off at closing or assumed by the purchaser. It is not sufficient to merely reinvest the net equity received upon sale. The purchase price of the Replacement Property must equal or exceed the aggregate of the net equity received upon sale of the Relinquished Property plus any mortgage encumbering the Relinquished Property at the time of the sale closing.

Example: If the Relinquished Property is encumbered by a \$700,000 mortgage and is sold for \$1 million as part of a Section 1031 exchange

transaction, to defer all taxes, the purchase price of the Replacement Property must be at least \$1 million, not merely \$300,000.

When can the Exchangor obtain access to unused proceeds?

Proceeds from sale of the Relinquished Property may be accessed only when the exchange is completed, fails, or expires.

If no potential Replacement Properties are identified within the Identification Period, the exchange fails, and the Exchangor may receive the funds. Those funds will, however, be taxed in the year received.

If all properties identified within the Identification Period are acquired within the Acquisition Period, the exchange is completed, and any remaining funds may be received by the Exchangor. Those remaining funds are taxable.

If less than all identified properties are acquired, but the Acquisition Period expires, all remaining funds may be received by the Exchangor, but are taxable.

These are the basics. As tax rates rise, Section 1031 exchanges will become increasingly valuable.

A Section 1031 exchange is not a new and exotic tax shelter scheme. Tax deferred exchanges of like-kind property have been recognized by the Internal Revenue Service as a valid tax deferral strategy since the early 1920s. The structure and effect of a Section 1031 exchange were specifically authorized by Congress by enacting Section 1031 of the Internal Revenue Code, and the Internal Revenue Service has promulgated extensive regulations for its implementation.

Use Section 1031 to your advantage, and prosper.

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*As required by the Internal Revenue Service under Circular 230, you are advised that any U.S. federal tax advice contained in this article is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed in this article.*