Monday, June 7, 2004

Real estate's best-kept secret: 1031 Exchanges

EAST BAY - If you're like me, you've paid close attention to the rapid rise in real estate prices, particularly here in southern New England. Compared with stocks, real estate over the past five years has been an extremely attractive investment tallying consistent gains.

Many owners, however, fearing a real estate bubble similar to tech stocks, would like to sell their property, but are deterred by potential capital gains taxes. This is not so much of a problem for gains on your personal residence, since as long as you've lived in a property for two of the last five years, you can exclude up to $250,000 in gain from your tax bill. If you're married, then the amount effectively doubles to $500,000.

This tax bill is not as easily avoided for real estate purchased as an investment. What's considered investment real estate? Pretty much anything that is not your primary residence, including raw land, apartment buildings, office buildings, single-family homes and even that vacation property. In most cases you will be on the hook for any gains realized on the sale of this property. And it could be a big bill, depending on the property and how long you've owned it.

Delaying the tax

Although there's no way to entirely avoid this tax, it is possible to delay it, perhaps indefinitely. The mechanism that allows this is referred to in section 1031 of the IRS code. It allows for the exchange of one piece of like/kind property for another without paying capital gains tax on the sale of the first.

While 1031 exchanges can be applied to any piece of real investment property, their most apparent and potentially valuable use is with real estate. The process is not difficult, but the requirements are very specific.

If you have investment real estate you'd like to unload, here are some tips to get you started.

* First, let's assume you've owned an apartment building for six years that is now worth $500,000. Your basis in the property (in other words, the initial purchase price plus improvements) is $250,000. If you sell the property outright, your long-term capital gain would be $250,000. Between state and federal taxes, you could owe $50,000 or more in taxes.

Rather than sell the property outright, you could choose to exchange it for another property you thought was a more attractive investment. What's nice is that despite the term "like/kind," you are free to choose any type of real estate. You can exchange your apartment building for a single-family home, an office building or even raw land.

In order to make this a legitimate exchange in the eyes of the IRS, you must never take constructive receipt of the money. When you sell the original property, closing proceeds must be transferred into escrow with a "qualified intermediary" — this is an independent third party who will hold the funds until you close on the sale of your new property.

* Timing is critical. The IRS gives specific deadlines you must meet to complete various phases of the transaction. The first deadline is identifying your new piece of property. The IRS requires that within 45 days after closing on your old property, you identify in writing up to four other properties you might purchase. You don't need to have a purchase and sales agreement signed, nor do you have to buy all four properties. But the one you do buy must be on that list. Once you have identified your candidates, you have 180 days from the original closing to close on the new property.

* At that closing, your qualified intermediary will transfer your escrowed proceeds directly to the seller. You would then contribute any additional money needed to complete the transaction. When you file your tax return, you will also file form 8824 which will indicate the exchange. You will not owe any tax on the gain.

* While you can trade down in value, it's important to remember any gain that is not rolled over to the new property will be taxed. So, if you exchanged your $500,000 apartment building for a $400,000 office building, you'll owe taxes on the $100,000 that you took out of the deal.

* What if you no longer want to own investment real estate? Speaking from experience, owning and managing investment property can be a lot of work. People easily tire of chores like maintenance, finding tenants and other property headaches. One alternative is to exchange your property for minority ownership in a much larger property. Many national real estate firms offer such "tenant in common" programs. Through one of these programs you could become a fractional owner of a class A office tower in some other part of the country, as an example. Each month the management company who acts as a general partner would send you your share of the rent. Meanwhile, your original investment remains untaxed until you sell it and actually realize the gain. The yields on these arrangements can be attractive and also allow you to diversify your real estate holdings to other parts of the country.

The net net

So where does this all end? The two alternatives are that you either end up selling your property or you die with it. If you chose to sell the property and realize your gains, you will be forced to pay the capital gains taxes you owe. If the sale represents a lifetime of real estate investment, the gains could be substantial.

However, if you string these exchanges out for the rest of your life and die with the property, your estate will receive a step up in basis, meaning the basis now becomes equal to value at date of death. This means that the gains you realized in your life will be essentially erased. New gains would start to accrue beginning at your death so your beneficiary could sell the property immediately and pay little or no capital gains tax.

For some great information on the 1031 exchange process check out the website www.1031ri.com. You will find information on how to proceed, as well as answers to frequently asked questions. 1031 exchanges are a great tool, but come with some pretty specific requirements. When considering this transaction, be sure to consult with an experienced advisor. With some preparation you might be able to have your cake and eat it too.

Mr. Tutt is a Certified Financial Planner designee and managing Partner of Blackstone Capital Mgt. in Providence. You can reach him at 228-0100 or askoliver@blackstonecapital.com. He is also an instructor of Investments at Bryant College and a registered representative of Investment Advisors and Consultants, 804 West Park Ave., Ocean, NJ 07712; 732/493-1722.

The 1031 exchange step by step

* Place your property up for sale

* Find a "qualified intermediary"

* At closing on your property, transfer proceeds of sale into escrow with your qualified intermediary.

* Within 45 days of closing identify in writing up to four potential exchange properties.

* Close on one of the four properties within 180 days of the closing on your original property.

* File form 8824 along with you tax return the following year.

BY OLIVER TUTT

Back to Top   e-mail this story | print it |

Contact Us   About Us   Classifieds   Subscriptions   Home

PO Box 90 Bristol, RI 02809-0090 - 401-253-6000