

Avoid Paying Capital Gains

The fundamentals of 1031 Exchanges

Many savvy investors utilize a powerful tax law that allows the investor to “pass through” their capital gain to another real estate investment without paying taxes on the gain. Sound too good to be true? It’s called a 1031 exchange. It’s a program that allows an investor to sell an investment (such as a rental property, a commercial property, or a business), and use the full proceeds as a down payment on another real estate investment, without paying taxes immediately on the gain.

This article is an introduction to the process of using this tax-deferring product. Although the process is not very complicated, to properly complete an exchange, you should seek the advice of a good accountant and possibly an attorney to assist you in navigating the legal waters of exchanges. Using an exchange, the “realized” gain is not eliminated, but the taxes due are postponed until you eventually sell the new property. You may even be able to continue to exchange, thereby “trading up” after you’ve fully depreciated your property, and keep postponing the gain until it passes on to your heirs!

Why are Exchanges a good idea

An investor can defer the taxes that would have been paid on the gain that they made when selling a property. This gain can be deferred indefinitely. You can even shift money from residential or urban investment properties to commercial real estate. Thinking about buying a condo on the beach to rent out as an investment? You may be able to sell your 4 unit in the city and apply all the proceeds to purchase that condo.

Some investors actually take the equity from a single property and purchase multiple properties with the gain. For example, let’s say an investor has a 3 unit residential property that they purchased 10 years ago. Their property is depreciated to the point where the investor would owe a significant percentage of their profit to capital gain taxes. The investor can sell the building, and use the proceeds to put down payments on 3 investment properties instead of the one they own currently, thereby leveraging their equity.

Loren Keim of Century 21 Keim Realtors explains “Exchanges are a great way of diversifying or consolidating your portfolio of holdings. An investor may want to change the type of property in which they’re investing, or an investor may want to use the equity to leverage more property.”

Some ground rules

Rule #1: For an exchange to work, the property must be sold for a “like-kind” property. Our experience has been that “real estate” can be substituted for virtually any other “real estate” property. Whether you’re exchanging a commercial building for a farm, or a multi unit for a shore condo, the new property is seen, in the eyes of the IRS codes, as a continuation of the original investment.

Rule #2: The investor cannot ever take possession of the profit or funds from closing! The profit is transferred, at closing, to a certified Exchange Agent. The Exchange Agent then transfers the money to the settlement for the property the investor is purchasing.

Rule #3: The third rule is timing! In order to make an exchange work, you, as an investor, must identify, in writing, the property which you want to purchase for the exchange, within 45 days of the date you sold the original investment property. You CAN identify more than one property, just in case one doesn't work out.

The investor has up to 180 days to complete an exchange, and the IRS does not make extensions! If you're exchanging one investment property for two or three, all purchases must be within 180 days of the earliest property sold.

Peter Shaffer, from Shaffer & Associates Accounting in Allentown, says "Investors needs to avoid taking any boot." According to Shaffer, boot is any cash or any other thing of value that is not part of the real estate, like a car or boat received as part of the down payment on the property the investor is selling. "Make sure your exchange company or attorney carefully reviews all aspects of your exchange, so you don't make any mistakes!"

"Tax deferred exchanges are one of the best kept secrets in the real estate industry" according to Keim. "An investor can continually increase their net worth by leveraging equity in property that would ordinarily be paid in Capital Gains Taxes." Shaffer points out "IRS regulations change, so make sure you talk to a professional about the implications of doing any sort of exchange."

Calculating a "Realized Gain" for the IRS

When calculating a gain for taxes, you must first determine the "adjusted basis" for the property, and then calculate the gain on which you would pay taxes.

Formula for Adjusted Basis:

Original Cost: _____

ADD: Improvements: _____

SUBTRACT: Depreciation: _____

EQUAL: Adjusted Basis: _____

Formula for Realized Gain:

Sales Price: _____

SUBTRACT: Cost of Sale: _____

SUBTRACT: Adj Basis: _____

EQUALS: Realized Gain _____