

## *Does your property qualify for a 1031 Exchange?*

A 1031 Exchange is the section number of the IRS code that details the method of deferring the payment of the tax on capital gains from the sale of a property which is not your primary residence. In an ordinary sale of real estate, (except for the sale of a primary residence inhabited by you for at least two out of the last five years), capital gains are taxed on any gain realized on the sale of a property. But in a 1031 Exchange, you must reinvest the gain from the first sale into another property "of like kind." This term simply refers to another property or properties that are also investment/rental properties. Bare land also qualifies as property eligible for a 1031 Exchange. The beauty of the 1031 exchange is that the taxpayer may dispose of property without incurring any immediate tax liability. Most importantly, it allows the taxpayer to keep the "earning power" of the deferred tax dollars working for himself in another investment. In effect, it is like an "interest free loan" to you from the IRS. By continuing to sell and buy rental properties or land this "loan" can be increased through subsequent exchanges.

Additionally, this tax liability is forgiven upon the death of the taxpayer: **THE ESTATE NEVER HAS TO REPAY THE TAX.** The heirs inherit the property at the time of the taxpayer's death at fair market price. The properties that are sold and purchased do not have to be the same type of properties. For example, you may own a single family home and you may exchange it for two condo units or any combination of properties up to three individual investment properties as long as the total market value of these properties at the time of the identification period does not exceed 200% of the value of the original relinquished property. This may be done again after the next property has been owned for a year and a day.

*How does it work?:*

1. Both the old and the new properties must qualify as investment or business use. If both properties pass this test, you can exchange nearly any properties.
2. List the "relinquished" (old) property for sale with a realtor who will disclose the intent to complete an exchange on the listing agreement.
3. The seller enters into contract with a buyer for the sale of the relinquished property and obtains the buyer's cooperation.
4. The seller notifies a "Qualified Intermediary" who prepares the exchange agreement and coordinates with the escrow holder. The exchange documents must be in place and signed by all parties prior to the close of escrow. The QI may not be a friend, employee, your banker, realtor, accountant or attorney. The QI must hold all the money that is to be transferred.
5. You have 45 days from the closing date of the first property to identify a list of properties you may want to buy. There are no exceptions to the 45 day deadline.
6. From the date of closing, you have 180 days to close on the purchase of one or more of the properties you have identified from the 45 day list. There are no exceptions.
7. Title for the new property must be taken in exactly the same "name" or entity as the old property.

8. To defer all of the capital gains tax, you must purchase a property of equal or greater value than the one you sold. Also, you must reinvest all of the cash proceeds from the sale.

### *What if I just don't do an exchange?*

A common question is how to determine what tax consequences if you don't do an exchange. Here is a simple way to calculate it.

**Depreciation Tax** - First, you will be taxed at a maximum rate of 25% for all of the depreciation you've taken (or could have taken) on the property up to the amount of gains realized.

**Federal Capital Gain Taxes** - If you've held the property for over a year (long term), your tax rate will be 15% on the amount of gain in excess of the "depreciation tax" discussed above. If you've held it for less than a year (short term), you'll be taxed on the gain at your marginal tax rate. You CAN offset this amount on your tax return with capital losses from other sources.

**State Capital Gain Taxes** - You'll be taxed on the total gain by the state in which you live. If the property is in a state different from the one you live in, you'll probably owe tax in that state as well.

#### **Example:**

Let's say you originally bought the property for \$200,000 and sold it for \$300,000, leaving a gross capital gain of \$100,000. And, let's say you took \$60,000 in depreciation. Assuming 6% (\$18,000) in broker's commissions and \$2,000 in other costs associated with the sale, here's what you'll owe. I've used 5% for the state's tax rate in this example.

Net Cap Gain:  $\$100,000 - \$18,000 - \$2,000 = \$80,000$

To this, add \$60,000 for depreciation recapture to give **\$140,000** in taxable gain

Depreciation Tax	\$15,000 (\$60K x 25%)
Federal Long Term Cap Gains Tax	\$12,000 (\$80K x 15%)
State Long Term Cap Gains Tax	\$ 7,000 (\$140K x 5%)
<b>Amount you'd owe</b>	<b>\$34,000</b>

Since every situation is different, you should consult your CPA or tax attorney for the actual tax in your situation.