

## Why exchange real property?

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To save taxes, yes, but said more succinctly, to build your estate with pre-tax dollars. Using proper exchange techniques will result in what is effectively interest free money from the government.

Taxes you owe can be paid later, allowing you the use of that money today to buy more or more expensive investment property. Other reasons to exchange include:

Increasing depreciable basis by acquiring property encumbered with a larger debt.

Acquiring sheltered income by exchanging for unimproved land for improved property.

Acquiring property without cash, when sales may be impossible.

Consolidating assets by exchanging many properties for one larger property.

Receiving nontaxable cash by exchanging and refinancing after an independent of the exchange.

Diversifying holdings without tax consequence.

Example of how not paying the taxes will allow you to build your estate faster:

If you acquired an investment property for \$50,000 and sold it for \$150,000 you would have a \$100,000 capital gain (that is not including the gain you would realize because of depreciation taken during the holding period of the property, which lowers the basis and results in higher realized gain). After taxes (30% for the purpose of example, state and federal), you would end up with \$70,000 to do what you like with, but let's assume you will use it as a down payment in another property.

Sell	\$150,000
Buy	\$ 50,000
Gain	\$100,000
Tax Bracket	30%
Tax	\$ 30,000

Balance to invest: \$70,000

Taking that \$70,000 and leveraging it 4 to 1 would result in a purchase of a \$280,000 property. 10% annual appreciation in year one would result in an equity increase of \$28,000.

If you structured the sale in accordance with section 1031, and did not have to pay the taxes at the time of the disposition of the first property (exchanging it instead of selling it), you could invest the entire \$100,000.

Leveraged at the same 4 to 1 ratio would allow you to purchase a \$400,000 property. At the same 10% rate of appreciation, your increase in equity in year one would result in a \$40,000 increase in equity. Multiply this added \$12,000 equity buildup over a 20 year investment horizon and the result is substantial.

Internal Revenue Code Section 1031 says no gain or loss shall be recognized

(taxed) if property held for investment is exchanged solely for a property of like kind to be held either for : 1. Production of income 2. Investment 3. Productive use in trade or business

Property must be of "like kind." This means real property for real property, personal property for personal property. "Like kind" is broadly defined, that is, all real estate qualifies regardless of the "grade or quality." It is the "nature or character" of the property (realty or personalty) and not the name of the improvements (office building, apartment, hotel, etc) that determines "like kind". This was emphasized in Commissioner of Internal Revenue v. Chrichton. This case involved the exchange of mineral interests and improved real property. The mineral interests were held to be like kind property because under state law they were considered real property. In a subsequent revenue ruling, the IRS indicated that water rights also met the like kind test.

Property not qualifying

1. Stock in trade
2. Partnership interests
3. Stocks, bonds, notes
4. Dealer property

Multiple Properties

Nothing in Section 1031 prevents a taxpayer from exchanging out of or into multiple properties.

Tax Consequences

Exchanges can be fully deferred or partially deferred. Any unlike kind property received in the exchange is considered boot and is recognized (taxable) in the year of the exchange. Boot is:

1. Cash or the equivalent of cash
2. Any unlike kind property
3. Mortgage relief
4. Any combination of the above

Cash paid offsets mortgage relief boot. The lower of the gain or the boot is taxable in the year of the exchange.

For a completely tax deferred exchange you must trade up in equity, value, and loan.

Basis of Property Received

This is referred to as substitute basis and is the Fair Market Value of the property received minus the deferred gain (or plus any deferred loss).

The Exchange Process

As it is in any real estate transaction, you must first identify the objectives of the property owner. What do they want to accomplish?

Management problems, lack of control, cash flow, tax concerns; sometimes the owner is not sure of all the circumstances and it may take some time and counseling to make the determination. A basic requirement is that all participants receive the same value that they give. The end result should be that there are as many winners as there are participants. Determination of value to the participants in a real estate exchange is not complete without considering the improvement the transaction will make in the owner's life.

The analysis must take into consideration the personal circumstances of the participants lives.

## Two Party Exchange

As mentioned before, to structure a completely tax deferred exchange, the investor must acquire property (properties) with equal or greater equity and a larger fair market value than the property transferred (up in equity and value). This assumes that there is gain realized and that the taxpayer pays boot and assumes a larger loan.

The very common three party exchange is comprised of a sale and an exchange, or an exchange and a sale.