

Sy Accountancy Corporation

Member, American Institute of CPAs

704 Mira Monte Place, Pasadena, California 91101

Tel (626) 744-0200 • Fax (626) 744-0300 • vsy@victorsycpa.com • www.victorsycpa.com

TAX DEFERRED 1031 EXCHANGE

By Victor Sy, CPA, MBA

A certain provision in the Internal Revenue Code allows you to **defer (postpone,) gain** on the sale of a business or investment property. In effect, you “trade” your property that, if sold, would cost you a great deal of taxes. Read on and learn some basics on what is often referred to as **1031 exchange**.

"Tax deferred" means that the tax is postponed (**not forgiven**). The number "1031" is a section of the Internal Revenue Code of 1986 (used to be 1954) which allows such preferential treatment of the gain.

For example, you purchased property for \$200,000 many years ago and have taken \$50,000 depreciation since then. You sell it now for \$400,000. Your gain is \$250,000 (\$400,000 less cost of \$200,000 reduced by \$50,000 depreciation recapture). The total tax is about \$60,750 (\$37,500 federal and \$23,250 state). If you receive a down payment of \$80,000 (20% of 400,000), you would end up with negative cash after paying commissions, escrow, and title fees, assuming that you carry a note for the buyer.

Would you sell if you know these figures before you sign a contract? Probably not. Ask your tax adviser to compute estimated taxes before you sign that deposit receipt. At least, place it as a condition of the contract.

How does one structure a 1031? Let us review a few rules.

1. The property must be business or investment (rental apartment), not personal (home or family car).
2. The properties must be of like kind (apartment for apartment, apartment for store, business car for pick-up). Even commercial building for raw land is O.K.
3. The exchanger (you) must not receive any "boot" (cash or other property that would be taxable).
4. Any Starker-type delayed exchange requires that the new property be identified within 45 days after the old property is sold (I suggest that a deposit receipt be signed within 44 days of closing the old property). You may designate a maximum of either:
 - A. Three replacement properties regardless of FMV, or
 - B. Any number of properties (more than three OK), as long as the total fair market value is not more than 200% of the total values of all properties given up.
5. The new property must be received within 180 days after the old property is relinquished. (**TIP**: Close escrow by the 179th day).
6. A like-kind exchange between **related parties** qualifies but will be subject to tax if the property exchanged is disposed within two years after the date of transfer. The gain that was originally sheltered will be recognized at the date of disposition. In other words, you don't have to amend the old return when you reported the sale.

It is safest to use four parties:

1. Exchanger - you, who wants to defer tax.
2. Buyer - the party who wishes to pay for the exchanger's property.
3. Target seller - has the like kind property you want (but who wants cash).
4. Intermediary - bank, title company, accommodator, facilitator.

Lastly, you will be glad to know that Congress did not plug this great loophole. Numerous restrictions such as strict interpretation of like-kind properties (lot for lot only, apartment for apartment only) did not pass. Only two new provisions made it:

1. Exchanges with a related party are not eligible for non-recognition treatment if one of the properties exchanged is disposed of within a two-year period.
2. Foreign real property and US real property are no longer like-kind property.

Development: IRS extended the 180-day deadline by another 120 days as a relief to taxpayers who are affected by presidentially declared disasters like Katrina.

Observation 1: Properly identify property within 45 days by designating a property in writing, signed, and delivered to the accommodator, escrow, or Title Company.

Observation 2: A Tax Court case (*Orville E. Christensen v Comm*) indicated that filing a tax return on time could make a like-kind exchange taxable! A tax trap can occur if you sell a property close to the end of the year (December) and buy a replacement property the following year (June). If you file your tax return on time (April 15), this shortens the allowable period from 180 days to about 105 days. You lose the period of time from the filing date to the end of the 180 days. It's therefore prudent to extend the filing date of your tax return to maximize the replacement period of 180 days.