Realty Exchange Corporation

WHY DO AN EXCHANGE?

by Ed Horan, *Certified Exchange Specialist®*

Recently I met a long time friend who is a real estate broker specializing in residential investment property. He mentioned that a few of his investment clients were selling smaller rental properties and moving up to a larger single property. This is an exchange situation that we see often. I told him that as a qualified intermediary, I hoped we could help him with their exchanges. Much to my surprise he said they were going to sell their property, pay the capital gains tax, and then purchase their new property.

I was very surprised by his response and wondered why they weren't taking advantage of a tax- deferred like-kind exchange. Being involved with exchanges on a daily basis, I realized we take for granted and fail to communicate to investors, real estate agents, and others the many benefits of an exchange. In this article I will try to explain the tax and investment benefits for doing an exchange.

Everyday we are reminded with full page ads by stock brokers and financial planners that we should fully fund our IRA and 401(k) type plans because the earnings on these funds are tax-deferred. We seldom see an article pertaining to the tax-deferred advantages of like-kind exchanges. We also see little explaining that IRA capital gains (not Roth IRAs) will be taxed when received as regular income, while deferred real estate gains will be taxed, if ever, at the lower 15% capital gains rate.

A Tax-Free Loan

For example, let's say you have two rental townhouses that you purchased ten years ago for $75,000 each, and you have taken approximately $45,000 in depreciation on each property. You can now sell each property for $150,000. It is your plan to purchase a rental house or commercial property in a nice vacation area. Let's see if Uncle Sam will help you. If you just sell the two properties and do not do an exchange, the federal tax (not counting state tax) will be computed as follows:

Total Selling Price			$300,000
Less Selling Costs		- 24,000	
Adj. Selling Price			$276,000
Original Cost Basis	$150,000		
Plus Improvements	zero		
Adjusted Cost Basis	$150,000		
Less Depreciation	- 90,000		
Tax Basis		- 60,000	
Taxable Gain			$216,000

The federal tax due on the gain of $216,000 is figured first by paying 25% on the recapture of the depreciation taken, $90,000 at 25%, or $22,500 in taxes, and then 15% on the remaining $126,000 of capital gain, or $18,900 in taxes. Adding the recapture tax and remaining capital gains (profit) tax together adds up to $41,400 in just federal taxes. Many investors forget that the depreciation allowed will be recaptured at 25% if the property is sold and not exchanged.

Time Value of Money

If you do a tax-deferred like-kind exchange for the new property, Uncle Sam will lend you the $41,400 you would have paid in capital gains tax interest free for as many years as you desire. Also, most states will defer the tax on what you owe them. So instead of paying the tax collector, you will have $41,400 additional cash to invest in your new property. If we use a conservative 10% appreciation rate and take advantage of the time value of money, then our $41,400 tax-free loan would grow in value in five years to $66,675 and in ten years to over $107,000, an increase of 159%. So if you sell and pay the tax, you not only give up the $41,400 in cash but also miss out on what that cash could earn over the coming years.

Another interesting aspect of an exchange is that when the replacement property is purchased, a new basis is established, and the depreciation deferred will, in the future, be taxed at 15% instead of 25%. In our example this alone is a $9,000 savings.

The Really Big Tax Break

If, after renting out your new house for one or two years, you may desire to convert it to your principal residence. Then, after living there for two years, you may sell the house and exclude up to $250,000 of the gain if single, and $500,000 of the gain if married filing jointly. This means that all of the deferred gain from your exchange and any new gain on the property may be excluded. The gain is forgiven and forgotten. Of course, the ultimate deferral of capital gains occurs when you die, and your heirs inherit the property at its current fair market value. Again, all the capital gain prior to your death is forgotten.

Non-Tax Reasons

The primary reason for doing an exchange is to defer your capital gains tax and to be able to reinvest all the cash equity without having to pay Uncle Sam. Some other reasons to do an exchange are to convert from non-income producing land to a revenue producing property; to relocate your investment property closer to where you live; to improve the quality of your property and get higher appreciation; to exchange one property for several properties, or vice versa; to decrease management responsibility by purchasing triple-net lease property; or by exchanging into a retirement or vacation community.

There are a few operational disadvantages to doing an exchange. First, the 45-day identification and 180-day exchange period time limits restrict the time an investor has to shop for replacement property. Second, even though you may refinance a replacement property after settlement, initially all the cash equity needs to be reinvested in the replacement property. And third, the replacement property must be like-kind, which means the replacement property must be held for investment, rental or business purposes. While this definition provides many options, it does not include stocks, partnership interests, a REIT, or dealer property.

If you are selling investment real estate and plan to purchase replacement real estate in the near future, it is foolish not to consider a tax-deferred like-kind exchange and take advantage of Uncle Sam's tax-free loan. Since every investor has a unique situation (such as having suspended passive losses), they should discuss any planned exchange with their CPA or tax advisor.

Go to www.1031.us and click on ***Gain Calculator*** to automatically compute the tax due if you were to sell your property.

This publication is designed to provide accurate information on tax-deferred exchanges. The publisher is not engaged in rendering legal or accounting services. If legal or tax advice is required, the services of a competent professional should be sought.

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