

The Tax Code Makes It: Possible To Exchange Taxes For Profits

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For many years prudent investment property owners have been using section 1031 of the Internal Revenue code to save money when they sell an investment property. Here's how they do it.

After the sale of an investment property, this part of the tax code allows a person to make a "delayed exchange." A delayed exchange allows a person to have a period of time to locate and close on the replacement property. It is called "delayed" because the replacement property is not identified prior to the sale of your existing property.

The delayed exchange allows owners of investment property to legally defer state and federal capital gains associated with the sale of that property.

In order to execute a delayed exchange taxpayers need to follow a few rules:

- The first thing to remember is that the exchange must be completed within 180 days of the close of escrow of the property that was sold. The time on the clock does not begin until the close of escrow on the sold property, but each calendar day is counted, including holidays.
- Upon the close of escrow, the taxpayer has 45 days to identify up to three potential replacement properties. Taxpayers are allowed to change their mind as many times as they wish within the 45-day period. However, once day 45

arrives, whatever property the taxpayer identified last must be used to complete the exchange. After this time the taxpayer will have an additional 135 days to actually close the transaction, thus completing 180 days.

- In finding appropriate replacement property the taxpayer must purchase property that value is at least as high as that of the relinquished property. The equity put into the acquired property must be equal to or greater than the equity gained from the relinquished property. The taxpayer must also replace at least the same amount of debt that exists on the replacement property. Any discrepancy in this area will subject the taxpayer to taxation on that portion only.

The tax code allows investment property owners to consolidate or expand their real estate holdings. For example, an older couple who owns several residential units may be interested in consolidating them all into one single property due to the ease of management.

Requirements

In order to complete a delayed exchange, two requirements must be met. First, you must use a disinterested third party to hold funds between the sale of the relinquished property and the purchase of the replacement property. The third party cannot be your attorney, CPA, escrow holder, or real estate broker. Using any of these individuals will disallow the exchange.

Second, you will need to have a series of documents outlining the exchange, and they must be signed by both the seller and buyer of the property.

Service Providers

There are companies that specialize in providing this service; they are known as qualified intermediaries, exchange companies, or accommodators. Exchange companies provide clients with experienced professionals dedicated to assisting taxpayers in completing

their exchange. These companies will provide the necessary documents and will coordinate the transaction with the closing agents and real estate professionals. Often these companies have extensive insurance and banking programs designed to make the exchange safe and efficient.

Next time you plan to sell your investment property, think about the potential of a Section 1031 Exchange. The savings can be significant, and with the assistance of exchange companies, the process is easy.