

Show Me The Money: Using Exchanges

It's been an interesting few weeks, a time when my wife and I have listed and sold an investment property and are now in the strange world of 1031 exchanges.

For many years we've owned an older home on a large lot, a property just a mile or so from a subway station. It's a place where deer graze in the backyard, the marble fireplace produces great warmth and the living room and dining room are large and architecturally distinctive. The house was also built to standards you don't find today: There are built-in cabinets, plaster walls and double wooden floors. If you want a comfortable home with a good location, this is it.

But over time the value of the property as a rental has been de-coupled from the value of the property as an asset. Local real estate prices have soared in recent years, but the ability of the property to generate rent has not kept pace. The problem? Structural obsolescence.

No matter how nice the house, no matter how well built, it's a 65-year-old home with three bedrooms and two full baths -- one on the second floor and a second in the basement. The closets are small and the kitchen has walls tiled from floor to ceiling. There's no great room, no walk-in closet and no cathedral ceiling. In an era when people eat out or eat quickly, a great dining room has less appeal than in the past. Simply put, a lot of renters are interested in features not found in this home.

On a personal level none of this bothers us. But in the contest for good renters -- folks who will be caring stewards of the property and pay their rent in full and on a timely basis -- newer properties seem consistently more attractive.

Earlier this year we decided to sell the property and then replace it with something that will generate more rent and also have the potential to appreciate.

Unfortunately, federal and state tax offices throughout the land view the sale of investment property as an opportunity to instantly bulk-up public coffers. If you simply sell investment real estate, even with the advantage of lower long-term capital gains rates, the total tax bill can still be huge, enough in some cases to underwrite a congressional investigation.

You can sell and bank the few dollars that remain after taxes, or you can sell and exchange -- and the tax money you save by exchanging can then be used to buy a bigger and better property.

The rules for a 1031 (or Starker) exchange are complex. By itself, the exchange agreement to hire a lawyer can run 15 pages, a suggestion of the legal intricacies to be observed.

In general, there are several basics to consider:

- You can't touch the sale proceeds with an exchange. You can look at the closing forms and admire the big number on line 420 (the gross amount due to the seller). You can marvel at the sums referenced on line 514 (the funds to be placed in your escrow account) but none of it goes into your pocket at closing. Instead, all proceeds go to an escrow fund maintained by your attorney.
- You have 45 days from settlement to "identify" replacement properties.
- You can "identify" up to three properties at fair market value or you can identify more properties providing their total fair market value is not more than twice the value of the relinquished property. For instance, if you sell a home for \$750,000 you can identify 17 replacement properties provided their total value is not more than more than \$1.5 million.
- There must be an actual purchase, generally within 180 days after the original property was transferred. However, other deadlines can come into play -- speak with an attorney for details.
- The replacement property cannot be real estate for your personal use. Instead, it must be used in trade or business or as an investment. However, what is today investment real estate may one day have value as a personal residence -- thus it can pay to find a home with multiple possibilities, especially because significant tax benefits may be available.
- An exchange may not produce total tax deferrals. If the adjusted value of the replacement property is less than the adjusted value of the relinquished property, then there may be taxable profits.
- Hang on to all records. A tax exchange defers taxes, it does not eliminate them. You could need settlement papers 20 or 30 years from now to determine profits and taxes, reason enough to retain such documents.
- As always in such matters, do nothing without first getting advice from a real estate attorney or a tax professional. Be sure to review IRS Form 8824, Like-Kind Exchanges (PDF).

Will we be able to identify a replacement property in 45 days? Sure -- we started looking well before closing and have been considering candidates with great glee. Why glee? Because even with the clock ticking, it's more fun to be a buyer.

For more articles by Peter G. Miller