

WHAT IS A 1031 TAX FREE EXCHANGE?

Thousands of transactions involving the buying and selling of real estate take place every day. If you have ever sold any type of investment real estate you know that income tax consequences flow out of that sale. With regards to real estate, the general rule is that every sale or exchange of real estate results in the recognition of a taxable gain or loss by a seller. I want to explore in this article a major exception to this general rule.

It first needs to be noted that this article is going to focus on the sale or exchange of investment real estate, not residential real estate. The sale of your principal residence has special rules that apply. Generally, when you sell your residence, you can exclude up to \$500,000 of gain from income tax on a joint return. If you sell your residence for over \$500,000, the following discussion on 1031 exchanges may have some application.

There is an available real estate investment tool which can save you from paying taxes when you sell or exchange investment real estate. Under what is called a 1031 exchange, there is no gain or loss recognized on the exchange of investment property, which is exchanged solely for property of like kind, and which is held for productive use in a trade or business or for investment.

An example may be helpful at this point. Lets say you bought a farm several years ago and paid \$100,000 for it. Your tax basis in that property is \$100,000. You decide to sell the real estate and much to your surprise you can sell it for \$500,000. When you close on the sale of your farm you are realizing a gain of \$400,000 (the difference between your basis in the property and the sale price). If you assume an approximate tax on your realized gain of 20% (15% federal and 5% for state and county taxes) then you are going to be on the hook for approximate taxes in the amount of \$80,000. You will then have approximately \$420,000 to reinvest.

Using this same example, but applying Section 1031, if you follow proper procedures and identify appropriate replacement property for your farm, then you still have a realized gain of \$400,000.00, but because you have reinvested the proceeds from the sale in like kind property then there is no \$80,000 in tax to pay and you have an available \$500,000 to reinvest.

It is interesting that the term “like kind” real estate does not mean the exact kind. As a general rule, all real estate is like kind. You may sell your farm for \$500,000 and reinvest it in residential rental property, or a industrial building. Undivided interests in real estate may be exchanged for full ownership.

If you have some investment real estate that you are looking to dispose of, you should at least look at the possibility of a 1031 Exchange. There are strict requirements involved in identifying replacement property for the transaction and you will need to get a Qualified Intermediary (QI) involved who you enter into an agreement with to acquire the relinquished property, sell it and then use the proceeds from the relinquished property to purchase a qualified replacement property. There are limitations on who may act as a QI in a 1031 Exchange.

There are some disadvantages of 1031 tax free exchanges. To the extent that gain is not recognized the tax basis for your replacement property carries over to that replacement property. There is also an increase in the transaction costs involved in a 1031 Exchange as compared to a straight sale.

If you are considering a 1031 Exchange, the sooner you get an attorney involved in the situation the better. There is certain language that should be in your written purchase agreement in order to qualify as a 1031 Exchange. Don't wait until it is too late!

You should all be able to appreciate this last paragraph of my article. Because this article deals with

tax issues, our friends at the Internal Revenue Service require that I give you this following Circular 230 Disclaimer: This disclosure may be required by the Circular 230 regulations as recently amended by the U.S. Department of Treasury and the IRS. The discussion of federal tax issues in the foregoing article is not intended or written by the author to be used, and it may not be used by any taxpayer, for the purpose of avoiding penalties that may be imposed on any taxpayer. The foregoing “legal-ese” is brought to you by your friends at the IRS.

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