LIKE-KIND PROPERTY EXCHANGE POPULAR TOOL TO DEFER GAINS TAXES

Guest Commentary by
Jonathan S. Horn

HORN CAPITAL REALTY, INC.
STRATEGIC CONVERSION OF REAL ESTATE TO CAPITAL™

1177 Kane Concourse, Suite 301
Bay Harbor Islands, Florida 33154
305-864-2000 * Fax: 305-864-4240
www.nnn4sale.com / jsh@horncapital.com

It's no secret. Real estate has not been immune to the economic slowdown. Consequently, sellers of property, faced with reinvestment worries and tax consequences, are more seriously considering the IRS Section 1031 exchange as a way to meet their investment objectives.

The IRS Section 1031 exchange (also known as like-kind property) is certainly not a new tax tool. It has been around since the 1920s. But the stock market's terrible lows, looming economic questions and lower rates of returns on savings accounts, bonds and CDs, are all working to popularize the 1031 exchange. A more friendly environment from the IRS also is helping to fuel interest.

U.S. Income Tax Code allows individual investors, as well as corporate owners of real estate, to sell their property and defer their capital gains by exchanging the proceeds from the sale of their asset for an investment in another like-kind property. IRS and U.S. Treasury regulations, however, are strict.

The 1031 works well for retail, commercial, office, industrial and multifamily holdings, as well as for undeveloped land.

To affect a 1031 exchange, the seller must place funds from the initial transaction into a special trust account designated specifically for this purpose. Banks, trusts or other financial institutions usually preserve such accounts, with an intermediary typically helping to implement the entire process.

Initially, when the IRS decided to reduce capital gains tax to 20 percent, many investors chose to take the tax hit rather than to defer the gain by utilizing a 1031 exchange because their reinvestment rate was tremendous due to the go-go days of the stock market.

Currently, deferring the gain makes more sense when one can trade into another property, particularly a single-tenant, net-leased (commercial, industrial or office) property at a stable rate of return. (A single-tenant, net-leased property is essentially a "long-term bond" of a corporation in the form of a lease document encompassed by real estate.)

Such leases, typically obligating the tenant to provide for building maintenance, insurance and real estate taxes and guaranteed by institutional grade credit, are ideal exchange candidates. Why? The individual or corporation obtains a conservative investment property with steady, long-term income, but without the responsibility for its rental or its day-to-day management.

The key, however, is to find a broker or source with a good "shopping cart" or "catalog" from which to chose quality, institutional grade, triple-net lease properties offering long-term investments.

The importance of the intermediary/facilitator/broker, is his experience in evaluating the properties, as well as the available financing, and to counsel clients who must review manifold properties within the brief 45-day period allowed under Provision 1031.

From the closing of the initial sale by a property owner, the seller has a maximum of 180 calendar days to complete the exchange. Within the first 45 days of that period, the seller has to designate candidate properties and appropriately identify them to the IRS. The seller may target as many as three properties — regardless of value — or a group of properties with a combined value not exceeding 200 percent of the value of the initial property sale. The funds in the trust account can be used as earnest money for the identified property, once all IRS regulations are met for a 1031 transaction.

The IRS has taken a few halting steps during the past year to improve the investor climate for 1031 exchanges. IRS guidelines, previously considered by many to be vague and open to interpretation, have been more clearly defined, and with published guidance on "reverse exchanges," investors are now precisely aware of what they can and cannot do.

Due to current market conditions, property owners/taxpayers often have been in a position of wanting to complete the acquisition of the new property before the old property could be sold, a situation termed a reverse exchange. Until September of last year, existing like-kind exchange tax rules did not apply to reverse exchanges.

Under the new procedure, the taxpayer must use an "exchange accommodation" titleholder to acquire and hold the new property while attempting to sell the old one. The time limits to accomplish a reverse exchange remain the same as a forward exchange. Unfortunately, the market does not always cooperate, but at least a method is now in place for the property owner/taxpayer to go either the reverse or forward exchange route. The time period for deferred changes is, in effect, doubled.

Last spring, the Joint Committee on Taxation proposed even more flexibility on like-kind exchange provisions. Briefly, the proposal would eliminate the need for intermediaries and would allow taxpayers to directly receive sale proceeds, which they cannot do under present regulations. Recommendations are a long way from legislation, however, but certainly bear watching.

Conclusion: In good times or bad, it makes sense to examine the IRS Tax Code Section 1031 option to defer capital gains and recapture taxes when selling a property and reinvesting into like-kind properties.

Reprinted from
Pittsburgh Business Times