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A Treasured Tax Break for the Smart Real-Estate Investor

Real-estate use of so-called 1031 exchanges, which let taxpayers defer capital-gains taxes after selling an investment property, survived the GOP tax overhaul

PHOTO: JOHN TOMAC

By Robyn A. Friedman

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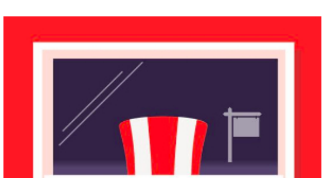
The tax overhaul enacted last year made a lot of changes, but one provision cherished by real-estate investors survived: so-called 1031 exchanges.

It's the name for a tax break that lets you defer capital-gains taxes on the sale of a property used for business or investment if you reinvest the proceeds in another business or investment property. It's often used by large real-estate investment companies, but individual investors—even those who own a single rental-income property—can take advantage of it as well. The "1031" name refers to section 1031 of the U.S. tax code.

"You don't have to be a professional investor to use this tax break to your advantage," says Andy Weiser, a real-estate agent with Better Homes and Gardens Florida 1st Real Estate in Fort Lauderdale, Fla. "You just have to be a smart investor."



One typical way small investors use the provision is by selling one rental property and buying another. Mr. Weiser recently represented an investor who did just that. The investor sold a two-bedroom rental property in San Antonio, for what would have been a

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$125,000 gain. If he had simply taken the cash, he would have paid capital-gains tax. But instead, under the 1031 rules, he was able to defer paying those taxes by using the proceeds to buy another rental property, a $395,000 two-bedroom waterfront condominium that he bought in Fort Lauderdale.

The provision only applies to properties held for business or investment; a personal residence is not eligible for the tax break. You also must complete certain steps at set times. You have 45 days from the date of the sale of the old property to identify potential replacement properties. And you must acquire the new property no later than 180 days after the sale.

Before the tax code overhaul this year, a variety of transactions—not just real estate—qualified for 1031 exchange treatment. These transactions, also called "like-kind exchanges," were allowed for any type of property used for business or held as an investment, including exchanges of personal or intangible property such as artwork or other collectibles. The new rules now limit exchanges to real estate only.

But many types of real estate qualify. An investor can exchange a single-family home held for investment in New York for a farm in Colorado or a small strip shopping center in Las Vegas, as long as all those properties are used for business or investment purposes.

Many investors engage in successive 1031 exchanges, effectively swapping each of their properties into bigger and better ones. Ultimately, when the investor dies, the heirs who inherit the last property receive a "stepped-up basis," which means that the property is valued at the market value at the time of death. If the heirs sell it then, there's likely no gain —and hence, no capital-gains taxes due—on the sale.

"You keep buying and selling and roll the profits from one to the next," said David Goss, co-founder and managing principal of Interra Realty, a brokerage in Chicago. "And when you die, and your kids inherit them, they get a stepped-up basis so the capital gains are gone forever."

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Here are some things to consider if you're interested in a 1031 exchange.

• **Don't forget about your vacation home.** Interested in trading up to a larger or more-expensive vacation getaway? Consider converting your vacation home from personal use to business use by renting it out for at least 14 days a year for two successive years before the sale. After that, you can exchange it and defer capital-gains taxes as long as you continue to rent for a minimum of 14 days a year for two years after the sale, says Steve Moskowitz, a tax attorney in San Francisco. Consult with a tax adviser for details; there are limitations on your

years after the sale, says Steve Moskowitz, a tax attorney in San Francisco. Consult with a tax adviser for details; there are limitations on your personal use.

• **Make sure the deal makes business sense.** Don't do a 1031 exchange just to avoid taxes—the deal needs to make good business sense as well. If it doesn't, consult with a tax attorney or financial planner to consider other tax-planning strategies.

• **Beware of personal property.** Personal property is excluded from like-kind exchanges. So, if you're exchanging an apartment building and it has appliances, you need to determine how much of the value is attributable to the building and how much for the appliances. "That's an area where you have to watch out," Mr. Moskowitz says.

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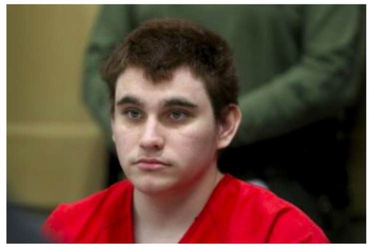

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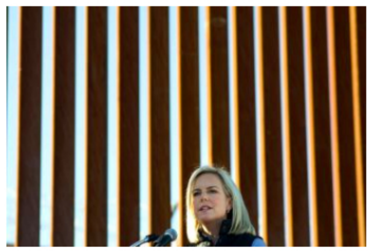

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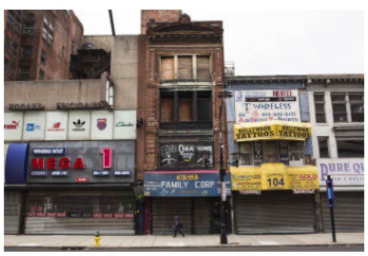

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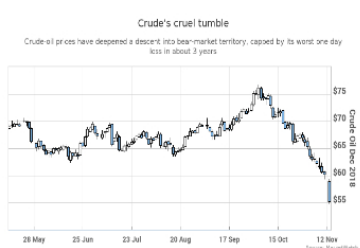

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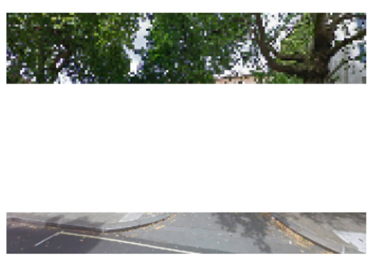

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