

## **Defer Taxes With a Property 'Swap'**

Investors who want to cash in their chips on real estate bought as an investment - but defer the tax bill, in some cases forever - can do so by trading into another piece of property.

This strategy isn't new, but it's enjoying a resurgence in popularity now because many investors believe that real-estate values have peaked in some markets. They want to lock in their gains and shift into other holdings without a big payment to Uncle Sam.

The stratagem is called a 1031 exchange, but it doesn't actually require you to swap property with another real-estate investor. You sell one property and buy another, carefully abiding by certain restrictions and time limits.

A section of the tax code known as 1031 allows investors to make a "like kind" exchange of investment properties and thereby defer, and in some cases avoid, capital-gains taxes. (The maximum federal long-term capital-gains rate is currently 15%, while some states impose an additional tax.)

You can swap just about any kind of investment property for another -- such as an apartment house for land, or a house for a store. Investors can keep exchanging into new properties of equal or greater value, while deferring the tax hit. If you hold property until death, the capital gain is erased altogether because your heirs inherit the property at its market value, making this a popular estate-planning technique as well.

### **'Best-Kept Tax Secret'**

"It's the best-kept tax secret," says Stephen A. Wayner, first vice president at Bayview Financial Exchange Services LLC, a unit of Bayview Financial, a Miami real-estate investment, development and mortgage-finance company. "There are so many people that should be doing it. They just don't know about it."

The tax savings can be substantial -- and by deferring the tax bill, investors have more capital to reinvest into the next property. Take, for instance, an individual who purchased a rental duplex 10 years ago for \$150,000 that's now worth \$500,000. If he simply sold the property, he would owe \$52,500 in capital-gains taxes. (This doesn't include any state taxes that might be imposed, nor does it include any depreciation recapture tax which could be owed if the owner took deductions for depreciation.)

But by conducting a 1031 exchange, he could use the entire \$500,000 as a down payment on a more expensive property. If you acquire a property of lesser value, you pay tax on the difference.

To get the tax benefits, however, there are caveats and very specific rules which must be followed carefully. Individuals cannot use their primary residence as part of a 1031 exchange; it must be an investment property or one that's used in a trade or business. (The exchange option also isn't available for financial assets such as stocks and bonds.)

### **Limited Time to Pick**

While there are a few ways to structure an exchange, the most common is known as a deferred or delayed exchange. When a property is sold, a "replacement" property must be identified within 45 days of the sale closing, and a deal must be completed within 180 days.

An independent party -- known as a qualified intermediary, who can't be your real-estate broker, lawyer or accountant -- must hold the sale proceeds until the next property is bought.

"Once the taxpayer takes control of the proceeds, it violates the like-kind exchange and the spirit of the rule," says Robert Klein, a tax partner in BDO Seidman LLP's Woodbridge, N.J., office.

Be sure to coordinate with your tax and legal advisers, along with the qualified intermediary, to be sure you're doing everything correctly. To find a reputable qualified intermediary, you can contact the Federation of Exchange Accommodators, a qualified intermediary trade organization based in Philadelphia. It has a "QI Locator" link on its Web site, [www.1031.org](http://www.1031.org).

### **Ask Plenty of Questions**

Once you find an intermediary firm in your area, make sure the people are experienced. After all, these are the folks who will be keeping watch over your proceeds. Key questions to ask: Are they insured and bonded? Do they engage in many 1031 exchanges, or only a couple a year? Who gets the interest on the account?

Fees vary. A \$500,000 or \$1 million exchange would cost approximately \$2,000, says Dennis Helmick, president of the Exchange Accommodators group, but it also depends on who's earning interest on the account and for how long it's held. Bayview's Mr. Wayner says fees average around \$750.

By TARA SIEGEL BERNARD  
*August 13, 2006*

[tara.siegel@dowjones.com](mailto:tara.siegel@dowjones.com)