TAX-DEFERRED EXCHANGES

Tax deferred exchanges are a valuable way to grow your portfolio. Over the years, I have helped dozens of clients complete successful 1031 tax deferred exchanges.

The time to think about exchanges is before you place a property on the market. In order to prevent problems from the IRS, all the paper work, the listing agreement, deposit receipt, and the escrow instructions should show that it is your intention to complete a tax deferred exchange.

A 1031 exchange will allow you to sell a property held for investment and purchase for one or more properties of equal or greater value and pay no taxes on the transaction. The sale of any real estate which is not the owner's residence, and which has been held for investment or business use (not dealer property), can qualify for a 1031 exchange including:

- Rental house
- Vacant lot
- Office building
- Store
- Warehouse
- Duplex
- Multi-family units
- Farm
- Ranch
- Mini-storage center
- Resort rental property

All qualifying property is interchangeable (i.e. bare land for a rental house is OK). Almost all exchanges involve the use of a neutral party called an Accommodator.

What is a tax-deferred exchange?

The tax-free exchange, as it is commonly called, is really not “tax free.” It is actually tax deferred. This means the tax that would normally be due on the disposition (sale) of the property is delayed or deferred until the future *if* the transaction conforms to the rules of Section 1031 of the Internal Revenue Code. In such an exchange (called a “1031”) the property that the client wants to sell is called the “old” property or the “relinquished” property. The property the client wants to purchase (exchange for) is called the “new’ property or the “replacement property.” Assuming that you want to execute a 1031 exchange, the term *sale* refers to the marketing of the relinquished property and the term *purchase* refers to the acquisition of the replacement property; together these equate to a successful 1031 exchange.

Why Would an Investor Want to Exchange?

The following is a list of possible reasons why an investor may want to exchange:

1. The client is determined to sell for some/any reason (age of neighborhood or maintenance expenses or whatever).
2. The client is tired of residential rentals and wants commercial or vacant land.
3. The client wants to switch into faster-appreciating investments.
4. The client wants to get rid of appreciated non-income-producing vacant land and buy income-producing investments
5. Federal and state capital gain taxes can exceed 22 percent of the capital gain.
6. The client sells fully depreciated property and buys a more valuable property, thus creating a new tax shelter.
7. The client wants to leverage up his or her investments.
8. The client wants to defer payment of tax liability to take advantage of the “time value of money.”
9. The client wants to rearrange his or her holding in anticipation of death.
10. The client wants his or her investment property to be near his or her principal residence.

Some sellers believe that a tax deferred exchange involves two parties trading their property to each other. This happens only rarely. Most exchanges involve three parties:

1. a buyer for the exchanger's property
2. the exchanger, and
3. a separate owner who sells the new replacement property to the exchanger.

Also exchanges can involve multiple parties and multiple properties.

There are very strict rules pertaining to completing a successful tax deferred exchange that include disclosures in the listing agreement and escrow instructions and time limits to identify properties and close the escrow.

INSTALLMENT SALES

What is an Installment Sale?

An installment sale involves the seller of a property carrying back some of all of his equity in the form of a loan to the buyer.

Example: Phil sells a fourplex that he owns free and clear for $180,000. He agrees to accept a down payment of $40,000 cash and loan the buyer $140,000 with a note and first trust deed. Some of his gain is immediately taxable. As he receives principle reduction each year, it is taxable in the year he receives it. It spreads the gain over several years, keeping the seller in a lower tax bracket.

Advantages of an Installment Sale

Advantages of an installment sale to the buyer(s) include:

- Low closing costs – There is no loan origination fee, credit report, or discount points. There are some closing costs, which are optional but should be recommended by an agent, such as a survey, title search, title insurance, and home inspection.
- Fast closing – There is no waiting period for mortgage approval. Closings can take place in days, not weeks.

The advantages to the seller(s) include:

- Fast closing, for this type of sale gets the property off the market, and the seller receives some of the proceeds in just a few days.
- Creation of an annuity for the seller and heirs.
- Future property taxes paid by the buyer(s).
- Buyer purchases homeowner insurance policy showing the seller as first mortgagee.
- Buyer responsible for all future maintenance
- Seller collects negotiated interest rate instead of depositing sales proceeds in a bank at a lower interest rate.
- This type of sale spreads the capital gains tax over the life of the loan. Taxes are paid only on the portion of the capital gain received in each year. The total payments are broken down and taxes paid as follows.
    1. Interest: Federal and state taxes, no Social Security or Medicare
    2. Cost basis portion: no tax
    3. Depreciated capital gain: 25 percent – could be as low as 15 percent (recapture)

4. Appreciated capital gain: 15 percent maximum (could be as low as 5 percent.

- Seller in a lower tax bracket at retirement would pay even less taxes on the interest portion of the installment payments.
- Installment sale often used when the residential property needs repairs and does not qualify for new conventional financing.

Disadvantages of Installment Sales

There are a number of potential disadvantages of installment sale. A seller can decide if the advantages outweigh the disadvantages.

What if Buyer Defaults?

If the buyer defaults, foreclosure is the seller's remedy. Foreclosure costs money for an attorney and takes some time. With proper safeguards, the possibility of foreclosure can be reduced or the costs of the foreclosure can be reduced. As a general rule, the smaller the down payment, the greater the risk of foreclosure.

NOW THE BAD NEWS

Next let me tell you that both of these tax benefits, tax-deferred exchanges, and installment sales are subject to change at any time by the whim of Congress and I have already mentioned it is very important to you as an INVESTOR to keep up with any potential changes that our political representatives are considering.