Oklahoma Association of REALTORS®

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1031 Tax-Deferred Exchanges:

An introduction to a powerful tax strategy

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What does investing in real estate have in common with the game of Monopoly? Winning at both requires acquiring the most valuable real estate by exchanging less desirable properties for more attractive ones. For real estate investors, it's easier to finish a winner by understanding the benefits of Internal Revenue Code Section 1031 tax deferred exchanges. By utilizing this powerful tax strategy, property owners no longer need to leave the outcome up to "Chance."

Tax deferred exchanges have been a part of the tax code since 1921 and are one of the last significant tax advantages remaining for real estate investors. One of the key advantages of a §1031 exchange is the ability to dispose of a property without incurring a capital gain tax liability, thereby allowing the earning power of the deferred taxes to work for the benefit of the investor (Exchanger) instead of the government. In essence, it can be considered an interest-free loan from the IRS.

Basic Tax Deferred Exchange Requirements

Although many investors mistakenly believe an exchange requires a "swap" of properties, most exchanges completed now are variations of what is called a "delayed" exchange. In a delayed exchange, the property currently owned is called the "relinquished" property and must be exchanged for like-kind "replacement" property. The IRS allows up to 180 days between the sale of the relinquished property and the purchase of the replacement property. There are a number of requirements that need to be met to qualify for tax deferral under the tax code.

Requirement #1: Both the "relinquished" and "replacement" properties must be held for investment or used in a business. The IRS uses the term "like-kind" to describe the type of properties that qualify. Any real estate held for investment can be exchanged for any other real estate held for investment. This definition covers a vast variety of developed and undeveloped real estate. Properties which are clearly not like-kind are an investor's primary residence or property "held for sale." The relinquished and replacement properties need not have identical functions (e.g. both be residential rentals or commercial strip centers). For example: Stewart owns two residential duplexes in Durant. He can sell them, buy three residential duplexes in Stillwater, and not pay tax on the gain from his Durant properties; or Stewart owns five acres of undeveloped farmland. He can sell it, buy a 12-unit garden apartment building in Oklahoma City, and not pay tax on the gain from his farmland; or Stewart owns three rental homes in California. He can sell them, buy a retail store in Tulsa, and not pay tax on the gain from his California properties.

Requirement #2: The IRS requires an investor to identify the replacement property(ies) within 45 days from closing on the sale of a relinquished property. The 45-day identification period begins on the closing date, and the replacement property(ies) must be properly identified in a letter signed by the Exchanger and received by the Qualified Intermediary.

Exchangers have a number of ways to properly identify properties. They may identify up to three target properties without regard to their total fair market value (Three Property Rule). Alternatively, they can identify an unlimited number of replacement properties, if the total fair market value of all properties is not more than twice the value of the property sold (200% Rule). As a final option, an Exchanger can break both of these rules if they acquire 95% of the aggregate fair market value of all identified replacement properties.

Requirement #3: Close on the replacement property by the earliest of either: 180 calendar days after closing on the sale of the relinquished property or the due date for filing the tax return for the year in which the relinquished property was sold (unless an automatic filing-extension has been obtained). Example: If an Exchanger closes on the relinquished property on December 27, the 180 day period will end after April 15 (Tax Day) unless the Exchanger files an automatic extension of time to file their taxes by April 15. Exchangers may choose to close both transactions within a shorter period of time, thereby avoiding the potential hardship of the 45/180-day time limits.

Requirement #4: The most common exchange format, the delayed exchange, requires investors to work with an IRS-approved middleman called a "Qualified Intermediary." The Qualified Intermediary actually documents the exchange by preparing the necessary paperwork (Exchange Agreements), holding proceeds on behalf of the Exchanger, and structuring the sale of the relinquished property and purchase of the replacement property.

To defer all capital gains taxes an Exchanger must buy a property or properties of equal

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or greater value (net of closing costs), reinvesting all net proceeds from the sale of the relinquished property. Any funds not reinvested, or any reduction in debt liabilities not made up for with additional cash from the Exchanger, is considered “boot” and is taxable. Example: Stewart sells his duplex, which he held for investment, for $160,000. A hundred days later he closes on a different duplex, which he will hold for investment, for $110,000. Stewart banks the $50,000 in excess funds for his child’s education. Stewart must pay capital gain taxes on $50,000. (In this example Stewart chose to take some money out of his exchange and pay the tax.)

When Are Capital Gain Taxes Paid?

Maybe never. Many investors mistakenly believe they will “have to pay the taxes sometime” so they might as well just sell. Quite often, this is a bad decision. The tax on an exchange is deferred into the future and is only recognized when an investor actually sells the property for cash instead of performing an exchange, and no interest is charged on the taxes deferred. Investors can continue to exchange properties as often and for as long as they wish, thus moving up to better investments and putting off the taxes for many years. The extra purchasing power generated by deferring the taxes will produce increased income and larger investment holdings. Finally, if the investment property is left in the taxpayer’s estate, at death the capital gains taxes are wiped away forever.

Unlike those playing Monopoly, real estate investors don’t have to depend upon a “roll of the dice” to pass GO and collect more money. Property owners should utilize tax deferred exchanges to acquire the desirable “Boardwalk” and “Park Place” properties and win the investment game!

Greg Lehrmann, Attorney, is Oklahoma Division Manager for Asset Preservation, Inc. and was an exhibitor at the 2002 OAR Education Conference & Trade Show. He may be reached at 866-266-1031 or *greg@apiexchange.com*.

This information is not intended to replace qualified legal and/or tax advisors. Every taxpayer should review their specific transaction with their own legal and/or tax counsel.

GRI Dean’s Awards

Recent REALTOR® Institute Modules have produced a number of Talova Jones Dean’s Award winners. The Dean’s award goes to Institute students who score among the highest in each module. This year’s winners are Glenn Bacher, Ponca City; Hanny Basso, Claremore;Becky Blessen, Stillwater; Steven Bittle, Norman; Doug Emde, Stillwater; Carolyn Faircloth, Edmond; Kelly Hackler, Stillwater; Pat Hand, Shawnee; Marcy Leonard, Edmond; Peg Malloy, Oklahoma City; Paula Pittlman, Oklahoma City; Andrew Rhynes, Tulsa; Edward Rudd, Oklahoma City and Linda Sands, Shawnee.

See the 2003 REALTOR® Institute schedule in this issue of *Broker Associate* magazine or click on Education at ***OklahomaRealtors.com*** for a complete schedule and information about the GRI designation.

Chesnutt Named 2002 OAR REALTOR® of the Year

Tommy Chesnutt, right, is congratulated by Neil Worster after the REALTOR® Celebration Banquet.

Ponca City REALTOR® Tommy Chesnutt, GRI was recently honored as the 2002 OAR REALTOR® of the Year. Chesnutt is broker-owner of Chesnutt, REALTORS®.

Chesnutt received the award at OAR’s REALTOR® Celebration Banquet, held in conjunction with the Education Conference & Trade Show at the Marriott Southern Hills in Tulsa. The banquet featured tributes from past OAR presidents Margaret Barton, Charles Harris and Rodger Erker, President-Elect Peggy Pitts, Jo Ann Lake, Marcie Smith, Talova Jones and Chesnutt’s daughter, Reagan McAuley.

Since 1957 OAR has selected a member to be honored as the REALTOR® of the Year. Nominations for the award are submitted by 27 local boards and associations from across the state, and the final selection is made by a committee comprised of previous REALTOR® of the Year recipients. The award was created to honor REALTORS® who live by the REALTOR® Code of Ethics, encourage others in the real estate profession to live by the Golden Rule and set an example of true REALTOR® spirit.

Chesnutt is an active member of the state association where he serves on the Board of Directors, the Education/REALTOR® Institute and Association Meetings committees and the RPAC Trustees. He is also a past district vice president. On the local level, he is the 2002 president of the Ponca City Board of REALTORS® and has served that board in numerous capacities.

Chesnutt actively participates in activities that benefit The American Cancer Society, Hospice, Domestic Violence and the Opportunity Center. He and his wife, Becky, are members of Grace Episcopal Church in Ponca City.

When accepting the award, Chesnutt and his daughter shared some touching personal stories that illustrated what a giving father he is in addition to his devoted service to his industry and community.