Facing capital gains on investment property?

BY BENNY L. KASS

Last in a series.

"Taxation with representation ain't so hot either." — Gerald Barzan, humorist

If you own investment property, and you sell it this year, you will have to pay 15 percent capital gains tax to the Internal Revenue Service.

This does not include the up-to-25 percent recapture tax on any depreciation that you took over the years. Next year, unless the Supreme Court throws out the new health-care law, the tax rate will be 18.8 percent.

Why? Because of a special 3.8 percent Medicare surtax on unearned income, which includes the sale of rental properties and even your second home at the beach. This will kick in Jan. 1.

There is a way to defer your tax obligation. It is called a Starker exchange, named after a man who successfully convinced the courts that based on the exchange of real estate, no tax was immediately due.

The law establishing this like-kind exchange can be found in Section 1031 of the Internal Revenue Code. The rules are complex, but here is a general overview of the process.

Section 1031 permits a delay (non-recognition) of gain only if the following conditions are met:

First, the property transferred (the "relinquished property") and the exchange property ("replacement property") must be "property held for productive use in trade, in business or for investment." Neither property in this exchange can be your principal residence, unless you have abandoned the property as your personal house.

Second, there must be an exchange; the IRS wants to ensure that this is not really a sale and a subsequent purchase.

Third, the replacement property must be of "like kind." As a general rule, all real estate is considered "like kind" with all other real estate. Thus, a farm can be exchanged for a condominium unit, a single-family home for an office building, or raw land for commercial or industrial property.

There are some tax consequences. If you do a like-kind exchange, your profit will be deferred until you sell the replacement property. However, the cost basis of the new property in most cases will be the basis of the old property. Discuss this with your accountant to determine whether the savings by using the like-kind exchange will make up for the lower cost basis on your new property.

A simple exchange (A and B swap properties) rarely works. Not everyone is able to find replacement property before they sell their own property. In the case involving Starker, the court held that the exchange does not have to be simultaneous.

However, it is not an open-ended interpretation. There are two major limitations:

- The replacement property must be identified within 45 days after you transfer the "relinquished property." You may identify more than one property as replacement property. However, the maximum number of replacement properties that the taxpayer may identify is either three properties of any fair market value or any number of properties as long as their aggregate fair market value does not exceed 200 percent of the aggregate fair market value of all of the relinquished properties.

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Furthermore, the replacement property or properties must be unambiguously described in a written document. According to the IRS, real property must be described by a legal description, street address or distinguishable name (e.g., "The Excalibur Apartment Building").

- The replacement property must be purchased no later than 180 days after the taxpayer transfers his original property, or the due date (with any extension) of the taxpayer's return of the tax imposed for the year in which the transfer is made.

These are very important time limitations, which should be noted on your calendar when you first enter into a 1031 exchange.

In 1989, Congress added two additional technical restrictions. First, property located in the United States cannot be exchanged for property outside the United States.

Second, if property received in a like-kind exchange between related people is disposed of within two years after the date of the last transfer, the original exchange will not qualify for non-recognition of gain.

There is an interesting loophole that might be attractive to many owners of rental property. Say you have found your dream retirement house in Florida, or Delaware, or anywhere in the United States, for that matter. If you do a 1031 exchange now, and obtain title to the replacement property where you ultimately want to live when you retire, you can rent out that property until you decide to move. Then, once you have established the new property as your principal residence, if you live in it for at least two years — and more than two years have elapsed since you sold your last principal residence — once again you can exclude up to $250,000 (or $500,000 if married and you file jointly) of the gain you have made.

Although the IRS has given us no guidance as to how long you have to use the replacement property as "investment" property, the general consensus is that you should rent out the property for at least one complete tax year.

Thus, depending on the numbers and the facts, you may ultimately be able to avoid some — or even all — of the capital gains tax which would normally be due when you sold your investment property.

The IRS has also authorized taxpayers to engage in "reverse Starkers," where you buy the replacement property first and then exchange (sell) the relinquished property. This is much more complex, and you should consult your own legal and tax advisers.