1031 Starker info

By thinking ahead, investors can defer taxes on property sale

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"We contend that for a nation to try to tax itself into prosperity is like a man standing in a bucket and trying to lift himself up by the handle."
— Winston Churchill

If you own a house as an investment and plan to sell it this year, you might want to give serious thought to a Starker exchange. If you swap one investment property for another following the rules outlined in Section 1031 of the Internal Revenue Code, you will defer taxes that would otherwise have to be paid.

And as of this year, those taxes can be quite hefty. Take this example: You are married, and your income is between $250,000 and $450,000. You have had good appreciation on that house you bought back in 1985, and you anticipate a profit of some $500,000. If you sell the house this year, in addition to having to recapture what you have depreciated in the past, you will have to pay a capital gains tax of 15 percent, the new Medicare surtax of 3.8 percent and any applicable state and local tax. If your income exceeds $450,000, your capital gains tax increases to 20 percent.

But if you conduct a 1031 exchange, no gain will be recognized, so you won't have to pay any capital gains tax.

The IRS has just issued proposed regulations interpreting and explaining how the new Medicare surtax works. One sentence in that proposal reads: "To the extent that gain from a like-kind exchange is not recognized for income tax purposes under Section 1031, it is not recognized for purposes of determining net investment income under Section 1411." In other words, if you do a 1031 exchange, you will not have to pay the 3.8 percent Medicare surtax. The regulations might not be finalized until later this year, but in the meantime, if you are considering selling your investment property, you have the right to rely on that language.

The simplest exchange involves a direct swap: I own House A, and you own Property B. At settlement, I give you a deed to my property (the "relinquished property") in exchange for a deed to your house (the "replacement property"). However, the logistics involved make this approach almost impossible to achieve.

Thus, we look to a Starker exchange. Many years ago, T.J. Starker sold a large tract of land in Oregon and told the buyer to keep the money until such time as he found a replacement property. A couple of years later, Starker bought the replacement property, and the money went directly from his buyer to the new seller. Starker took the position that under Section 1031, he did not have to pay capital gains tax. The IRS disagreed. However, the Ninth Circuit Court of Appeals agreed with Starker, and thus the Starker exchange became law.

Congress was not happy with the length of time involved in that case, so it narrowed the time frames. As the law is today, you have 45 days from the date you sell the relinquished property to identify the replacement property or properties. Then, within 180 days from the date of sale, you must take title to the replacement property. If your tax return for the year the property is sold comes due before the 180 days, you must either obtain an extension from the IRS or close before the April 15 tax filing deadline.

The question is always asked: Where is the exchange? This just looks like I sold House A and bought House B.

Yes, it does look like that. Courts in many cases have grappled with whether these transactions were sales or exchanges.

Typically, the courts look at two important factors. First, what was the intention of the taxpayer? Did he always intend to engage in a 1031 exchange, or was it an afterthought? That's why it is important for the seller to include the following language in the contract to sell as well as the contract to buy: "The parties understand that this is part of a Section 1031 exchange and agree to cooperate with each other."

Second, did the seller have control over the sales proceeds? Typically, the proceeds are held by an intermediary, selected by the seller. When the original seller goes to closing on the replacement property, the sales proceeds go directly to the intermediary. If the original seller has any control over those funds — even for one minute — the exchange will fail.

A 1031 exchange involves investment property; it is not available for your principal residence. It requires that the properties being exchanged are "like-kind," which in this case means that any investment real estate can be exchanged for any other investment real estate. For example, a farm can be swapped for a condominium unit; an office building can be exchanged for raw land. However, your vacation home is not considered "investment" property if you have made personal use of it.

Keep in mind also that the tax basis of the relinquished property becomes the tax basis of the replacement property. In other words, if the house you sold has a tax basis of $200,000, that will be the basis for the new house, even if you paid $1 million for it. That is why a Starker exchange cannot be called a "tax-free" transaction. If you ultimately sell the replacement property and do not do another exchange, you will have a lot of capital gains tax to pay.

If you are considering the exchange, talk to your accountant or financial adviser first. You might not have as much gain as you thought, and it might not be worth your while to spend the time and money involved in the process. Locating the replacement property within 45 days is often difficult, and these deadlines are carved in stone; they cannot be modified or extended.

Some investors would prefer just to pay the tax and enjoy whatever money is left. That is a decision that can be made only by you.

Benny L. Kass is a Washington lawyer. This column is not legal advice and should not be acted upon without obtaining legal counsel. For a free copy of the booklet "A Guide to Settlement on Your New Home," send a self-addressed stamped envelope to Benny L. Kass, 1050 17th St. NW, Suite 1100, Washington, D.C. 20036.