GREC

Georgia Real Estate Commission

GREC RENEWS

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Tax Deferred Exchanges: What a Licensee Should Know

When a property owner sells an investment property, he/she wants to avoid paying taxes on the gain as much as possible. The most common method to do this is to enter into a tax free exchange. The title is somewhat of a misnomer as it is not really tax "free," but more accurately described at tax-deferred. It is also referred to as a 1031 Exchange, a tax deferred exchange, a Starker delayed exchange or a like kind exchange.

If any type of investment property is traded for another investment property the tax on any gain on the sale is avoided. For example if a seller stands to gain $250,000 on the sale of an office building, and he/she is truly an investor, he/she will probably be purchasing another investment property and will use that gain to "trade up" his/her equity. This ability to transfer that gain into a more valuable property is an excellent way to increase the value of the investor's portfolio.

There are some important rules that must be followed in order to qualify for as a tax deferred exchange. In 1939 Congress passed a law that enabled like kind exchanges and the Internal Revenue Code 1031 specifies the conditions required to avoid the tax liability on the gain.

Although this article describes the basic idea and reasons for doing exchanges, the licensee should always refer the client or customer to a specialist who can handle the exchange transaction. The licensee is not an expert in exchanges and should not try to be one.

There are companies and individuals that can act as a Qualified Intermediary and handle the actual transaction for the seller. These parties hold any earnest money or other funds involved in completing the transactions as well as the documentation necessary to meet IRS codes. It is imperative that the funds be handled properly so that the seller avoids some unanticipated tax on the sale. It is critical that the party handling the exchange is well versed and experienced in exchanges. There are companies that only perform exchanges and do nothing else.

Some of the basic requirements of an exchange are briefly described below:

- The properties to be traded must be of Like Kind. Like is broadly defined as any type of investment property. For example a tract of land could be traded for an office building.
- Strict time limitations must be met in order to qualify for the tax benefits of the exchange
  - The seller has only 45 days to designate up to 3 properties that will be purchased for the exchange. Certain documentation must be available to the IRS regarding the identification of these properties.
  - The seller has only 180 to close on the transactions. The 45 days is included in this 180 day period.

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2008 Dates to Note

- **September 23, 2008 GREC Brokerage Course** Empire Board of Realists
- **September 24, 2008 GREC Trust Account** Empire Board of Realists
- **October 23, 2008 GREC Brokerage Course** Northeast Georgia Board
- **October 24, 2008 GREC Trust Account Class** Northeast Georgia Board

GREC Disciplinary Sanctions

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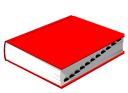

Focus on Terminology:

"Investment"

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Exchange Basics...

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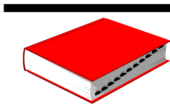
In addition to strict requirements for the exchange itself, the property owner must maintain records regarding the transfer of funds and the depreciable basis of the property for future evaluation once the acquired property (properties) is sold.

As noted earlier, the tax is avoided but not "free." "*When the replacement property is ultimately sold (not as part of another exchange), the original deferred gain, plus any additional gain realized since the purchase of the replacement property, is subject to tax." (Source* http://www.irs.gov)

Commercial real estate sales often involve an exchange. In fact most companies prefer to do an exchange on every sale if they own real estate. The licensee needs to understand the basic exchange concept but should not attempt to provide counsel or advice on the mechanics of the exchange. There are professionals that deal only in exchanges and there are numerous resources online for the licensee to become versed in describing the basic reasons for doing an exchange of real estate.

Resources on Exchanges

1. Internal Revenue Code 1031
   - http://www.irs.gov and IRS publications
     - Publication 544, Sales and Other Dispositions of Assets
     - Form 8824, Like-Kind Exchanges (PDF)
     - Form 4797, Sales of Business Property
2. Title Companies
3. Attorney experienced in tax issues and real estate transactions
4. Intermediary company or exchange facilitator
5. Trade Associations such as the Federation of Exchange Accommodators at http://www.1031.org/



Focus on Terminology: "Investment"

The word "investment'" can mean many things to many people. Generally the word investment is defined by ***Webster's*** as "*the outlay of money for income or profit."* The following is the **Internal Revenue Code** definition of Investment Property***:*** *This is property that produces investment income. Examples include stocks, bonds, and Treasury bills and notes. Property used in a trade or business is not investment property."*

In the real estate industry it is meant to describe a real property that provides a return on the money invested. This return could be in the form of a realized appreciation in value or income generated from the property on a regular basis or both. By definition, the term investment implies a profit or return of some sort on money paid out. So savvy investors use techniques such as the tax deferred exchange to maximize their return on investment.