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Investment Real Estate and the 1031 Tax Deferred Exchange

While some sectors of the commercial real estate market in Southern Illinois have yet to fully recover from the last economic downturn, investment real estate has been a notable exception. BARBERMurphy Group has experienced a very significant increase in sales of investment properties over the past few years, and investment real estate was by far the hottest sector in 2015.

You might already be familiar with the current Federal long term capital gains income tax rates for 2015, which vary based on your income tax bracket, for properties held more than 12 months. Those in the 25%, 33%, and 35% federal income tax brackets pay 15% on capital gains, while taxpayers in the 39.6% bracket pay 20%. Most will find themselves subject to a Federal capital gains income tax rate of 15%. However, you may not know that depreciation recapture is taxed for Federal income tax purposes at a substantially higher flat rate of 25%. You may be subject to state or local income taxes as well, so consult with your tax advisor for more information.

It is extremely important that you take capital gains taxes and depreciation recapture issues into account when evaluating the various options available to you for your real estate investments. Capital gains taxes and depreciation issues can have a significant impact on the after tax cash flow and capital accumulation of your real estate investment portfolio. Allowable depreciation, *whether deducted or not*, must be included in the depreciation recapture income tax computation upon the sale of your real estate investment. This means that you may have to recapture or add back into your taxable income the amount of depreciation taken on your investment property when you sell. This may be a big reason why you could benefit from an IRS Section 1031 Tax Deferred Exchange.

The 1031 Exchange is one of the best vehicles for building and preserving real estate wealth. The 1031 Exchange allows you to sell one or more appreciated investment real estate properties and defer the payment of your capital gains and depreciation recapture taxes by acquiring one or more like-kind properties in a delayed exchange.

Only properties held for business use and/or for investment can qualify for tax deferral. You can mix the classifications, i.e. a commercial warehouse (business property) exchanged for 100 acres of raw land (investment property). Property held for personal use or held primarily for sale (dealer property) does not qualify. Investors should make sure that they accurately identify replacement properties within 45 calendar days from the relinquished property closing. You may identify a maximum of three properties without regard to fair market value. You may identify any number of properties as long as (1) their total value at the end of the identification period does not exceed 200 percent of the value of the relinquished properties as of the transfer date, or (2) you actually receive identified properties having a market value equal to or greater than 95% of the total value of the identified replacement properties.

An exchanger has up to 180 calendar days to acquire like-kind replacement property measured from the day the relinquished property is sold. The exchanger must acquire like-kind replacement property that is equal to or greater in value than the relinquished property sold (based on net sales price, not equity); must reinvest all of the net proceeds or cash generated from the sale of the relinquished property; and must replace the amount of old debt that was paid off on the sale of the relinquished property with new

debt of an equal amount on the like-kind replacement property. Trading down in value and/or pulling cash out of your 1031 Exchange will result in the partial recognition of your depreciation recapture and/or capital gains income tax liabilities. The amount that is not exchanged for qualified like-kind replacement property is called cash boot or mortgage boot and will generate the recognition of depreciation recapture and/or capital gains.

The secret of a successful 1031 deferred exchange is avoiding actual or constructive receipt of money or other property, or any economic benefit during the transaction. To accomplish this, the exchanger must carefully select a Qualified Intermediary (QI) who actually obtains and transfers the property. The QI does not provide legal or specific tax advice, but will prepare documents, furnish escrow, and secure funds in an insured bank account until the exchange is completed.

It is easy to get tripped up on the many complex rules and regulations that the IRS sets forth. For example, when depreciable real property (section 1250 property) is exchanged for non-depreciable real property, such as raw land, then excess depreciation and 1250 unrecaptured gains are recaptured and is taxable at the time of the exchange, even though no taxable boot is received in the exchange. This is a tax trap that few investors are aware of. Executing a 1031 Exchange should be completed under the guidance of a seasoned professional such as a reputable commercial real estate investment firm. A knowledgeable professional is critical in assisting you with regards to assessing your tax liabilities, whether establishing an exchange suits your investment goals, or finding a suitable replacement property.

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