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Several new regulatory changes should generate a greater need for tax-deferred exchanges

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To say these are strange days for the 1031 qualified intermediary industry would be an understatement. Over the last eighteen months the industry has had to endure a perfect storm of negative market factors which resulted in a significant reduction of successful like-kind exchanges. The storm now appears to have passed, and ironically, despite the slowly recovering commercial real estate market, several regulatory changes could generate a substantially greater need for tax-deferred exchanges. More importantly, the changes should create a safer exchange environment. The following is a brief snapshot of some proposed regulatory changes and some changes that are already effective:

Proposed Changes in Federal Capital Gains Tax Rates: Because the Federal government will at some point be forced to rein in the federal budget deficit, most experts believe that a substantial increase in capital gains rates is imminent, and that the increased rate will be retroactive. According to The Kiplinger Tax Letter, the Obama administration will be recommending to Congress that the long-term capital gains rate be pushed to 20%, with some members of Congress supporting an even larger increase. A taxpayer's ability to complete a like-kind exchange will be imperative in avoiding the immediate tax recognition triggered by selling investment property.

2009 Change in Federal Gain Exclusion on the Sale of a Primary Residence: Many people are familiar with the \$250,000 exclusion of gains from the sale of a primary residence (\$500,000 for married couples filing jointly) that traditionally granted the tax break so long as the taxpayer owned and occupied their residence for two of the last five years leading up to the sale. However, recent changes to IRC Section 121 largely flew under the radar despite being effective for the 2009 tax filing deadline. These changes significantly reduce the amount of exclusion for many taxpayers. Now, taxpayers who alternated usage between primary residence and investment within the five year look back may receive only a prorated exclusion based upon how long the property was used as a primary residence. The remaining amount will be treated as a capital gain. While this is an unpleasant surprise for many property owners, Section 1031 is a source of possible tax relief and can be used to defer the remaining gain where the taxpayer will be purchasing new investment property.

Changes in State Tax Rates: If the specter of increased federal tax rates isn't incentive enough to facilitate a like-kind exchange, the additional burden of state tax increases will make the exchange a financial planning necessity. In fact, some cash-strapped states have already implemented new tax structures that will substantially affect taxpayers this year. Rhode Island, for instance, has done away with favorable capital gain treatment altogether. Whereas old rates hovered as low as approximately 1%, profits from the sale of real or personal property will now be taxed at the same rate as ordinary income, in other words at rates as high as 9.9%.

Greater State Consumer Protection: In addition to changes in tax rates, States have also taken the lead in consumer protection reform, and new industry regulations should lead to increased taxpayer confidence. Most locally, as of September 2009, the State of Maine now requires qualified intermediaries doing business in the state to be licensed. As part of the licensing process, the qualified intermediary must carry state-mandated fidelity bonds and errors & omissions insurance coverage. Further, qualified intermediaries must adhere to the prudent investor standard, maintain liquidity and take steps to preserve principal. Several other states such as California and Colorado have adopted regulations designed to protect exchange proceeds. Many more states are proposing similar legislation and the belief is that most states, if not all, will ultimately have consumer protection regulations that specifically address the exchange industry.

All real estate investors should be aware of these changes prior to conveying real estate so that they can make an informed decision whether they will benefit from deferring their capital gains. This way, they can properly utilize Section 1031's financial planning benefits.

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