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1031 tax straddling provides added incentive to taxpayers selling investment property at end of year

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Have you been feeling it? We have! Commercial real estate transactions have been up considerably in the last 2 years and a large percentage of those have been 1031 Exchanges. When speaking with our clients, the high volume of exchanges can be attributed to a number of motivations.

As real estate becomes more stable, investors are starting to look for ways to change or build upon their portfolios. Properties that had been steady investments through the recent downturn are now showing significant appreciation and equity. Since multiple properties can be acquired through a single Tax Deferred Exchange, investors can diversify their real estate portfolio, thereby hedging the investment risk inherent in a single property. These replacement properties can offer greater income and long-term appreciation potential.

For some, it's all about the taxes: The Affordable Healthcare Act (2013) imposed a new 3.8% tax on certain investment income, including capital gains, for those with an Adjusted Gross income of over a certain threshold. Additionally, the American Taxpayer Relief Act raised the top long-term capital gains rate from 15% to 20% for those with higher taxable income. Both of these, combined with the 25% Depreciation Recapture Tax and applicable state tax, cause a substantially greater amount of equity to be due to the federal government at tax time. Exchanging became an even more valuable tool for investors to preserve their equity!

Beyond the basics, however, some may not realize that IPX1031Â® offers an array of professional services, including working in conjunction with the investor's tax and legal advisors to navigate the specifics of the Code, offering creative tax strategies with proven solutions for building wealth, preserving profits and maximizing investment dollars.

One of these strategies comes into play this time of year. With the end of 2014 approaching, there are investors selling real estate who are not sure whether to initiate a 1031 Exchange because they are concerned about securing replacement property to complete their exchange.

The good news is that there might be a back-up benefit for them - 1031 tax straddling - which provides added incentive to most taxpayers selling investment property at the end of the year.

If a taxpayer successfully completes a 1031 Exchange, the main benefit is tax deferral. If a taxpayer is not able to purchase new property to successfully complete the 1031 Exchange, the taxes associated with the sale of their investment property will be due. With "tax straddling" the taxpayer may still receive a one year tax deferral thanks to installment sale rules (Â§453 / Publication 537). Assuming a qualified intent, tax straddling provides added incentive to taxpayers to sell their relinquished properties near year-end to take advantage of the significant tax-deferral benefits of 1031 Exchanges with the one-year deferral benefits of Â§453 as a back-up plan.

How does this work? In a tax deferred exchange, taxpayers typically have 45 days from the sale of the old property to identify potential replacement property and 180 days to purchase the identified property. Once a 1031 Exchange is initiated, if replacement property is not purchased to complete the exchange, the earliest the Qualified Intermediary can return the taxpayer's funds is on the 46th day (the day after the identification time period has ended) or, in some cases, the 181st day (the day the 1031 Exchange time period is complete).

Taxpayers who enter into a 1031 Exchange during the fourth quarter of 2014 and receive their funds back from the Qualified Intermediary in 2015 have the option of deferring payment of taxes on the profits from their sale until 2016 - the due date of their 2015 tax return. Combining Â§1031 with Â§453 permits the cash received from the Qualified Intermediary at end of the exchange to be treated as a payment in the year of actual receipt, rather than in the year the property was sold.

The IRS does not penalize investors for attempting to complete a 1031 Exchange. Tax straddling simply provides added incentive to taxpayers selling investment property at the end of the year...so why not attempt to complete a 1031 Exchange when a one year deferral is available as the back-up plan?

Taxpayers should consult with their tax advisors since tax straddling does not apply to all sales, and any gain attributed to debt relief will still have to be recognized in the year of sale. Please call us to discuss tax straddling and other solutions to determine if you can take advantage of these valuable tax-deferral methods.

Patricia Flowers, CES is VP for Investment Property Exchange Services, Inc. (IPX1031), Boston.