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The taxpayer should consider the advantages and disadvantages of an exchange - by Robert Charland

March 24, 2017 - Front Section

Robert Charland, Exchange Authority, LLC

The primary advantage of an exchange is that the taxpayer may dispose of property without incurring any immediate tax liability. This allows the taxpayer to keep the earning power of the deferred tax dollars working for him/her in another investment. In effect, this money can be considered an interest-free loan from the IRS. There is no interest paid or accrued on the outstanding loan balance and there is no specific call date or due date.

Moreover, the loan is forgiven upon the death of the taxpayer, which means that the taxpayer's estate never has to repay the loan. The taxpayer's heirs get a stepped-up basis on inherited property; that is, their basis is the fair market value of the inherited property at the time of the taxpayer's death. A subsequent sale by the heirs will be taxable only to the extent of the difference between the stepped up-basis and the net sale price.

The taxpayer should also consider the disadvantages of an exchange. These include the following:

• The taxpayer's basis in the new property (substitute basis) will be the basis of the old property, plus the increase in value between the new property and the old property, plus the amount of gain which may be recognized in the exchange. The substitute basis will always be less than the contract price of the new property. In fact, the difference between the contract price and the substitute basis will equal the amount of gain that was not recognized by virtue of the exchange. Consequently, the depreciation deduction will be less than the depreciation which would have been available had the taxpayer sold the old property and purchased the new property.

• There will be increased transactional costs for entering into and completing an exchange. Typical costs include possible additional escrow fees, attorney's fees, accounting fees, and the Qualified Intermediary's fees.

• The taxpayer may not, without tax consequences, use any of the net proceeds from the sale of the relinquished property for anything except reinvestment in other qualifying property. All proceeds from the sale must be used to acquire replacement property. At the termination of the exchange, any remaining proceeds not used in this manner may be taxable. To be 100% tax deferred, the taxpayer must acquire new property equal or greater in value to the net sale price of the old property and the taxpayer must spend all of the net proceeds of sale or more on the acquisition.

Before deciding whether or not to engage in an exchange, the taxpayer should carefully analyze all of his or her options as well as the economic impact of the exchange. A decision should not be based solely on the tax consequences of the transaction. Rather, business considerations should play the dominant role in the decision.

Business considerations include, but are not limited to, the need or desire to:

• Consolidate or diversify investments;

- Obtain greater appreciation on the new property;
- Increase cash flow;
- Relocate a business investment;
- Transfer into or out of a high basis or low basis property;
- Eliminate management problems;
- Upgrade the functionality of the property; and
- Exchange out of obsolete property.

Robert Charland, Esq., is CEO of Exchange Authority, LLC, Leominster, Mass.