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Profits in a bad economy: Buying and selling and using a 1031 exchange

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The economic times we are living through are strange indeed. Last week I had to explain to a friend how she could be facing a large tax on the sale of her building even though she was selling it for less than she paid for it two years ago. My friend is exceptionally sharp, but she just could not understand how she could have to pay taxes when she is losing money. In the last year, I have faced many clients in this same situation.

The story begins with a building she had owned for many years, which had appreciated greatly in value. She is a frugal investor and her building was unencumbered at the time of the sale. In addition, she had owned the building for so long it was basically fully-depreciated for tax purposes, meaning that her adjusted basis was quite low. She sold this building in 2007 at a nice profit. Rather than paying the substantial tax, she rolled-over the proceeds in a 1031 exchange and purchased a new building of equal value with no debt. The tax rules are clear that her basis in the new property in this situation is the same as her basis in the old property - very low.

Now, two years later, she is selling the building for less than the purchase price she paid two years ago. In her quite sensible mind, she thinks she suffered a loss and therefore should not have to pay any taxes. Unfortunately, the tax laws say otherwise. Because her basis in the property she is selling is so low (due to the rollover from the prior 1031 exchange), the sale will result in a taxable gain. In order to avoid the tax on this gain, she will need to do another 1031 exchange.

Consider some actual numbers to illustrate this scenario. My friend bought her original building in the 1970s for $100,000. Over the years, she paid off the debt and still reinvested $200,000 in improvements. Based on the tax laws in place at the time and due to the length of her ownership, her basis in 2007 was $10,000 (representing only the land - for which depreciation deductions are not allowed). She sold the building in 2007 for $1 million. (For purposes of this illustration, I will ignore closing costs and other adjustments). If she did not rollover the proceeds in a 1031 exchange, she would have recognized long-term capital gain in the amount of $990,000 ($1 million minus $10,000).

But, she had a smart CPA who advised her to contact us about a 1031 exchange. As a result, she acquired a new building for a price of $1 million. Thus, she had to recognize no gain and paid no tax. Now, though, she is selling the building for $750,000 at an economic loss of $250,000 ($1 million minus $750,000). However, for tax purposes, the calculation is quite different. She will have a long-term capital gain in the amount of $740,000 ($750,000 minus $10,000) and will be required to pay tax on this gain.

The solution for my friend is another 1031 exchange. She can use the proceeds to buy another building for $750,000. If so, her basis in the new building will be $10,000 and she will have effectively deferred the $740,000 gain. Once she understood how the tax system works in this case, she was absolutely intent on deferring the tax and buying a new property through another 1031 exchange. In fact, she is contemplating a Tenants-In-Common investment (TIC) or buying more than one replacement property. She is also considering selling one or more of her other properties and combining multiple properties into a single, larger replacement property. All of which are very good ideas.

We are also seeing similar situations arise in the context of foreclosures and deeds-in-lieu of foreclosure. Whether the debt is fully recourse or non-recourse makes a significant difference in how taxes are calculated.

The message my friend wanted me to pass along was the importance of fully understanding all of the tax consequences of any transaction early in the process. Consult with your CPA, tax attorney or other advisor who is knowledgeable in these matters. Only then will you be able to make an intelligent and informed decision.

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