

Gain, no pain

By: [Bernadette Starzee](#) February 22, 2016 0

As the real estate market has strengthened, Long Island accountants find themselves working on more Section 1031 exchanges.

When taxpayers sell real property at a gain, they generally have to pay capital gains taxes. But if they exchange one commercial property for a “like-kind” property under Section 1031 of the tax code, they can defer gains taxes and build wealth.

“As the market has improved, the amount of gain people are realizing or have the potential to realize on a transaction is rising,” making a 1031 exchange more appealing, said Peter Buell, a tax partner in the real estate group at Marcum, which has offices in Melville.

For instance, Buell has a client who acquired a building in Nassau County for \$11 million that is now worth \$36 million. Faced with paying \$25 million in gains taxes, the company chose to do a like-kind exchange and buy multiple properties, in addition to funding a private foundation that will shelter part of the gain.

“As real estate values go higher and higher, particularly in New York City, owners are more enticed to sell properties they bought a long time ago,” said Meyer Mintz, a tax partner at Berdon, which has offices in Jericho. “People generally hold onto real estate, but I think with values going up as quickly as they have in some areas, people that don’t typically buy and sell buildings are saying, ‘If someone’s willing to give me \$10 million, I’m going to take it.’”

For instance, he said, “Say someone’s father bought a building in Long Island City many years ago for \$100,000. Long Island City is the hottest area around, and let’s say the building’s now worth \$10 million. With a huge gain like that, the only way to sell it is through a like-kind exchange. Otherwise they would pay 35 or 40 percent taxes on the gain.”

Section 1031 is “a very taxpayer-friendly provision” that allows for some flexibility in what is considered like-kind property, said Edward Ichart, a partner in the real estate segment at WeiserMazars in Woodbury. Most real estate will be considered like-kind to other real estate; for instance, a commercial building can be exchanged for developable land. However, Ichart noted, “Properties must be used for business purposes or investment.” Real estate that is primarily for personal use, including primary residences and vacation homes, does not qualify.

Like-kind exchanges are popular tools used mainly by commercial real estate companies and real estate investors.

“Someone may use a like-kind exchange to move into a different asset class, such as buying an income-producing building as opposed to an asset that wasn’t producing,” Mintz said.

However, accountants warn that if a like-kind exchange is not done correctly, taxpayers may be subject to tax, interest and penalties.

For gains tax to be completely avoided, 100 percent of the gain must be reinvested in the new property or properties. Taxpayers have only 45 days after the sale date of the first property to identify a replacement property or properties, and the closing must occur within 180 days if they are to avoid recognizing the gain.

“What can happen is a target property may have an environmental issue,” said Buell, who recently was involved in a like-kind exchange in which an environmental issue held up the closing until day 179.

“There were a lot of nervous people,” he said.

To do a like-kind exchange, taxpayers must use a qualified intermediary to hold money from the sale in escrow until the exchange is completed.

“If you take possession of the money, it triggers the gain,” said Buell, who had one company come to him for advice after this happened on a previous transaction. “They were unpleasantly surprised.”

Another company came to Buell after learning it was being audited by New York State because of a previous 1031 exchange. Some of the firm’s partners had wanted out of the partnership and didn’t want to participate in the purchase of the new property, and the deal was incorrectly structured so that the original property was exchanged for partnership interests, when it has to be exchanged for real property.

Some property owners run into trouble when they do like-kind exchanges with properties in other states where they are not familiar with the laws and nuances. According to Marcum, some states do not recognize 1031 exchanges. Many require mandatory non-resident tax withholding that must be paid when property is transferred to a buyer. Some states require the properties being exchanged to be located in the same state.

Sometimes taxpayers can use other states’ rules to their advantage. For instance, Buell said, a New Yorker who plans to retire to Florida may sell a commercial building in New York and acquire a like-kind property in Florida, avoiding New York State sales tax on the gain. After moving to Florida, the taxpayer can sell the property and avoid paying state tax on the gain, since Florida is an income tax-free state.

Besides penalties for doing a 1031 exchange incorrectly, another potential pitfall is the fact that there is a lower basis in the replacement property for depreciation.

“If you sell an office building in East Meadow and you have a gain of \$1 million, and you buy an apartment complex in Smithtown for \$5 million, your basis in the property will only be \$4 million, so you will have less to depreciate,” Ichart said.

“Some companies find out the hard way that they really miss the depreciation deductions,” Mintz said. “Depreciation is based on the old tax basis; if I bought a building for \$100,000 50 years ago I don’t have any depreciation, and when I do the like-kind exchange, I still don’t have any. Say I do a CVS lease; I could wind up with what is known as phantom income. I’ll be receiving rental income and using that to pay down mortgage principal, which is nondeductible. The money is going to pay the mortgage, so I won’t have any cash from it, but the government will want tax on it. When you are using the income to pay an expense that’s not deductible, you’re being taxed on cash you don’t really have. That’s something that after a few years winds up costing some building owners more than they thought it would.”