

THE POWER OF SECTION 1031

Cash, Contribution, Bargain Sale, Installment Note & Section 1031

The object of a Section 1031 Exchange is to completely defer the capital gains tax, both federal and state, upon the sale of business or investment property and avoid any recapture of previously taken depreciation. It is necessary to go even or up in value, use all of the net cash from the sale of the old property and replace any debt that is paid off from the result of the sale. Since all real estate is "like-kind" all other real estate, the next hurdle is to identify the target property within 45 days of the sale of the Relinquished Property and acquire it within 180 days.

There are numerous ways to utilize Section 1031 without exchanging full value for value and still realize partial or full tax deferral. For example, it is possible to take cash at the closing of the Relinquished Property, however, that cash will be immediately subject to capital gains tax and recapture of depreciation and will negate the tax deferral that is the object of an exchange. It is also possible to sell the property using the installment sale method, thereby deferring the payment of tax until the actual receipt of the funds, presumably, over time. There is risk in positioning yourself as the lender, so beware. The other possibility is to create a structured sale by assigning the contract to a third party (usually an insurance company utilizing an annuity) who will provide a fixed return based on time and value.

An option with social impact is to sell the existing or relinquished property using a bargain sale. The notion of a bargain sale (a sale where the realized value is less than market value) conjures up visions of tax loss not capital gains. Bargain sales, whether in full or in part, to a qualified 501(c)(3) not-for-profit entity or municipality can produce several levels of tax benefits to the seller of the property. A case in point to illustrate: A property owner sold a tract of land to a nonprofit land trust and agreed to accept a lower price (bargain sale) for the opportunity to take a tax deduction for a charitable contribution. The market value of the property was \$160,000, the land trust agreed to purchase the property for \$90,000 and a charitable deduction of \$70,000 will be applied over the next five years against 50% of the individual's adjusted gross income (AGI). \$90,000 is exchanged for new Replacement Property by employing a Qualified Intermediary (QI). No tax is triggered at the time of sale; the personal income tax burden over the next five years is substantially cut; and new property is acquired using a Section 1031 Exchange.

This strategy will also work for the sale of conservation easements when the value of the development rights are sold and the underlying real property *remains* in the hands of the owner. Many small volunteer run land trusts operate nation-wide, protecting and preserving this country's unique character on a state by state basis. They are frequently asked to accept a donation of a conservation easement in exchange for cash. Since typically the cash must come from donations, this process is lengthy and often ranked on a priority basis. It can take years to raise the cash needed to protect a single project. One solution is to have the easement donated as a combined bargain sale of cash and tax deductions. With a five year carry-forward for the tax benefits of up to 50% of the donor's adjusted gross income, dramatic benefits can be realized under such a plan and the landowner can acquire new property with the cash portion of the sale.

Case Study Scenario: Client has approached the local land trust to donate a conservation easement on his 250 acre farm. The land is open and adjacent to other conserved property and has a development value of one million dollars. The client wants to preserve the property but is approaching retirement age and would like to have some cash and be in a position to acquire an investment property in Arizona to be rented to others. The client has indicated that he is unable to make a large donation but since he expects to continue working for the next five years, tax credits will be helpful.

The trust offers \$500,000 for the easement; \$250,000 will be designated as a bargain sale and deducted over time using up to 50% of the client's adjusted gross income (AGI). The balance will be raised by the land trust and targeted donors. The client employs a Qualified Intermediary (QI) to handle the transaction as a partial Section 1031 Exchange. At closing, the client decides to receive \$50,000 in cash and directs the balance of the funds to the QI, which are used to acquire property in Arizona, identified in 45 days and acquired in 180 days. The client earns \$100,000 AGI annually, allowing for a 50% deduction of the AGI, he will pay income tax on only one-half of that amount for the next 5 years.

It is easy to see the Power of Section 1031 and the many options that are available on the sale of business/investment property. Whether Replacement Property is the desired goal or a combination of cash, new property, installment sale or tax deductible contribution, Section 1031 can provide the pathway to your property investments.