How the New Tax-Deferred Real Estate Exchange Rules Can Make You Very Wealthy

A Special Report From Real Estate Expert Bob Bruss

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A few weeks ago, a subscriber in Florida wrote to ask why I write about the "same old stuff." Why don't you write about something new?" she asked. This report begins my 31st year of writing this newsletter so I must have been including *some* "new stuff" or the monthly circulation would not be at its highest level ever. Of course, we always have new subscribers joining us and a few dropping out as they retire or live off their real estate wealth.

One subscriber wrote a few months ago to renew his subscription for two years but he said, at age 92, this might be his last renewal! Then he added that my suggestion of selling his properties and taking back installment sale mortgages enabled him to retire very comfortably while collecting monthly mortgage payments from the buyers of his rental houses. He noted how much easier it is to collect mortgage payments than it was to collect rents and maintain the houses.

Many of my special reports from years ago are just as timely today as they were when written. Just between us friends, not much has happened in the last few years on the topics of equity sharing and discounted mortgage investing. So I haven't updated those reports recently, but we still have them available for new readers who are interested in those topics.

<u>But this special report is a classic example of both old and new material</u>. Fortunately, there's lots of "new stuff" happening in the field of tax-deferred exchanges. It has been over two years since we looked closely at the benefits of tax-deferred exchanges; a lot has happened since then.

<u>The basic exchange rules haven't changed – Internal Revenue Code 1031 and its predecessors have been in the tax code since 1921</u>. But there have been plenty of exciting new developments since then. *Just in the last year or so, we've had important new IRS exchange tax law interpretations and Congress enacted exchange rule changes as recently as October 22, 2004.* Let's get started!

<u>WHY MAKE TAX-DEFERRED EXCHANGES INSTEAD OF SELLING YOUR PROPERTY?</u> Some investors seem to enjoy paying taxes on their real estate sale profits. I don't. As a smart real estate investor, I hope you don't either. I still occasionally get letters from readers who say their real estate broker, their CPA, or their attorney advised them to sell their investment or business property and pay the capital gain tax instead of making a tax-deferred exchange.

Those letters shock me (they mostly come from the conservative New England states where many real estate attorneys and CPAs are not up-to-date on the benefits and easy rules for Starker delayed tax-deferred exchanges).

For some unexplained reason, realty investors and their tax advisers in a few mostly eastern states have been the last to catch up and understand the huge benefits of tax-deferred property exchanges. I still remember receiving a letter, about two years ago, from White Plains, NY where the investor said her CPA told her tax-deferred exchanges are "experimental" and haven't been tested yet in court! *Just for the record, tax-deferred exchanges are legal in every state and they are now even being done in the slow-to-catch-on New England states! But finding CPAs and tax or real estate attorneys who understand them still isn't easy there.*

The tax theory IRC 1031 tax-deferred exchanges is to create one continuous real estate investment, rather than a taxable sale followed by a purchase of another property held for investment or business use. Isn't it better to have the full amount of your sale profit available for reinvestment rather than have your profit diminished by a 15% to 25% federal tax (plus any applicable state tax)? *Avoidance of tax erosion is the major reason for tax-deferred exchanges.*

> **EXAMPLE:** Suppose you decide to sell your investment or business property. Your net profit (long term capital gain) will be $200,000. If it is a depreciable property, such as an apartment building or a rental house, your capital gain will be taxed at the special 25% federal "recapture tax rate" on depreciation deducted after May 6, 1997, and at the 15% maximum capital gains tax rate on the balance of your profit including pre-May 7, 1997 depreciation deducted. Rather than paying more than $30,000 federal capital gains tax on your $200,000 profit, leaving only $170,000 to reinvest in another property, wouldn't it be much better to have the full $200,000 available to acquire a larger investment or business property? Of course!

But there are many reasons other than "tax erosion" to make tax-deferred real estate exchanges, rather than creating a taxable sale followed by purchase of a replacement property. The "top 10" tax-deferred exchange reasons are:

1—Avoidance of income tax erosion of property sale profits and avoidance of depreciation recapture taxes upon the sale;

2—Minimize or eliminate the need for new mortgage financing on the property being acquired;

3—Get rid of an undesirable property, or one which is difficult to sell, and acquire one which is either more desirable and/or easier to sell;

4—Increase the investor's depreciable basis for greater tax shelter by acquiring a larger depreciable building;

5—Acquire a property which better meets the owner's needs, such as providing greater cash flow and/or requiring less management time;

6—Defer part of the capital gain profit tax by "trading down" to a smaller property which better suits the owner's needs. An installment sale note will spread the profit tax over several years while providing the seller with interest income at a rate higher than is currently available with safety elsewhere, such as bank CDs and savings accounts (of course, the interest income received is taxable as ordinary income);

7—Pyramid your wealth into a large estate without paying profit tax along the way each time you trade up to a larger property. That was the basis of the late William Nickerson's wealth pyramid in his famous best-seller classic book ***How I Turned $1,000 into $5 Million inReal Estate in My Spare Time*****;**

8—Refinance either before or after (but NOT as part of) the exchange to create tax-free mortgage refinance cash to make other investments or use the cash as you wish (the reason you can't refinance as part of the exchange is the cash is then considered taxable "boot" which is "unlike kind" personal property rather than "like kind" real property);

9—Accept an unexpected cash purchase offer to sell a currently-owned property at a high price without owing tax on the sale profit;

10—Completely avoid capital gains tax when the investor dies while still owning the last property in the chain of tax-deferred exchanges.

Death is the ultimate tax shelter of all! Although the net market value of your real estate owned at the time of death will be included in your estate, no capital gains tax will be due on your realty upon your demise. However, if you sell your real estate the day before your death, Uncle Sam will be waiting to claim his capital gain tax!

Estates of persons dying in 2004 and 2005 have a $1.5 million federal estate tax exemption. This exemption increases to $2 million for deaths in 2006, 2007, and 2008. In 2009, for deaths that year the federal estate tax exemption will be $3,500,000. But 2010 will be the best year to die because there is NO federal estate tax that year! However, unless Congress changes the estate tax law, the $1 million federal estate tax exemption returns in 2011, as do the higher pre-2002 federal estate tax rates on assets above the exempt amount.

THE SIMPLE TAX-DEFERRED EXCHANGE CONCEPT. Now that we understand why tax-deferred exchanges are so advantageous and the motivations for using them, let's discuss the simple tax-deferred exchange concept. As mentioned earlier, a tax-deferred exchange is viewed as one continuous real estate investment, rather than a taxable sale followed by a reinvestment.

To qualify for a tax-deferred "like kind" exchange of your investment or business real property, you must trade equal or up in both price and equity for another "like kind" property. If

you take anything out of the trade, called "boot," it is taxable because it is "unlike kind" personal property such as cash or net mortgage relief.

But there is no limit to the number of investment or business properties you can trade or acquire in a tax-deferred exchange. Also, there is no minimum holding time or frequency rule. Theoretically, you could hold your investment or business property just one day, then trade up, and then trade again the next day, all completely tax-deferred.

> **EXAMPLE:** A few weeks ago, I had lunch with my high school pal, David Woodhead. We go back a long way, first working together one summer at the municipal swimming pool. At lunch, David mentioned he and his charming wife, DeDe, are thinking of trading their two rental houses for one large rental house located in a better area. That's a perfect tax-deferred exchange of a "like kind" trade up of two properties for one large property. Or, they could trade for a warehouse or office building. All that matters is each "like kind" property involved in the tax-deferred exchange must be held for investment or business use. In other words, "like kind" does not mean "same kind" of property. They need not trade for another rental house. Of course, if they trade down to a property worth less than the total value of the two rental houses, then they will be receiving some taxable "boot" such as cash or net mortgage relief.

> **EXAMPLE:** Suppose you own a rental house worth $250,000, subject to a $50,000 mortgage. You want to use your $200,000 equity to trade up to a $600,000 commercial building with a $450,000 mortgage. *This is an example of a partially-taxable trade up.* Although you are trading up in price from $250,000 to $600,000, you are trading down from $200,000 to $150,000 equity in the acquired property. That means you will be receiving $50,000 taxable cash "boot" in the form of net mortgage relief.

> **EXAMPLE:** Instead, suppose you make the same trade from a $250,000 rental house up to a $600,000 commercial building, but you get a new $400,000 mortgage so you will have $200,000 equity in the acquired property. Now you have a fully tax-deferred exchange because you traded equal or up in both price and equity. However, if you need cash, either before or after the exchange you can refinance the mortgage to take out tax-free cash. Just be sure the refinance is not part of the exchange because then the cash you receive becomes taxable boot.

How to calculate your tax-deferred capital gain and basis for the property acquired in the exchange. Presuming a tax-deferred exchange capital gain is attained, the next question usually is "How much is my tax-deferred capital gain?" The answer is it is the difference between your old property's net price (called "adjusted sales price" in tax talk) minus your old property's "adjusted cost basis."

Net price, or adjusted sales price, is usually the gross sales price minus selling expenses, such as the real estate sales commission, transfer tax, and other closing costs you pay.

Adjusted cost basis is usually the old property's original net purchase price, plus closing costs which were not tax deductible at that time, minus depreciation deducted during ownership,

plus capital improvements added during ownership, minus any casualty loss deductions taken during ownership.

> <u>**EXAMPLE**</u>**:** To keep our example simple, suppose the buyer of our $250,000 rental house paid all the sales expenses so $250,000 is the net or adjusted sales price. Let's suppose you we paid $150,000 for this rental house, added $10,000 of capital improvements, deducted $50,000 of depreciation during ownership, and there were no casualty loss deductions. Therefore, our deferred capital gain is $250,000, minus the $110,000 ($150,000 + $10,000 - $50,000) adjusted cost basis, or $140,000 capital gain on which we defer tax by exchanging. To determine the new adjusted cost basis of the $600,000 building acquired in the tax-deferred exchange, *a simple method is to subtract the deferred capital gain of $140,000 from the $600,000 purchase price for the acquired property, resulting in a $460,000 adjusted cost basis for the $600,000 building.* This is a quick way to estimate your new adjusted cost basis for the acquired property.

In the above series of examples, there was a $140,000 tax-deferred capital gain on the sale of the rental house. The tax-deferred exchange tax savings were over $21,000, resulting in being able to use that $21,000 to acquire a larger replacement property rather than paying the $21,000 to Uncle Sam (plus any state tax).

<u>**Which property is NOT eligible for a tax-deferred exchange**</u>**?** <u>Before proceeding, it is important to emphasize that virtually any real estate held for investment or use in a trade or business is eligible for a tax-deferred exchange</u>. This is called "like kind" real estate.

<u>Property which is *not eligible* for a tax-deferred exchange</u> includes

1--Your principal residence (which is eligible for the far better Internal Revenue Code 121 $250,000 and $500,000 tax exemption if you owned and occupied it at least 24 of the 60 months before its sale);

2--Your vacation or second home (but you can convert it into a rental property, thereby making it eligible for a tax-deferred exchange);

3--Dealer property (such as a home builder's inventory), and

4--Partnership interests (unless recorded title is held individually in the names of tenant in common (TIC) co-owners).

<u>**Report your tax-deferred exchange on IRS Form 8824**</u>**.** Even if no tax is due on your tax-deferred exchange, it must be reports with your personal income tax returns. This form is not easy to understand so you might want to hire an experienced tax adviser.

If an exchange property is acquired from a related party in an exchange, it must be held at least 24 months otherwise the resale profit is taxed back to the original owner of the property. In a related party tax-deferred exchange, the IRS requires filing Form 8824 in the tax year of the exchange and for two years after that.

<u>THE SIMULTANEOUS TAX-DEFERRED EXCHANGE METHOD</u>. As long-time subscribers know, my first tax-deferred exchange was the trade of a three-unit building at 1264 Third Avenue (just down the steep hill from UCSF Hospital) for a nine-unit apartment building at 4605 Balboa Street (overlooking the famous Playland at the Beach) in San Francisco. *Having read in William Nickerson's great book about the benefits of tax-deferred exchanges for pyramiding real estate wealth, I was anxious to make my first tax-deferred trade.*

I shall always be grateful to Walt Lembi, and his dad Frank Lembi (now in his 80s and still selling real estate!), at Skyline Realty in San Francisco for showing me how "real world" tax-deferred simultaneous exchanges were done before 1984 (when "delayed" Starker exchanges became available).

<u>The first step was to find a cash buyer for my three units</u>. Walt and Frank took care of that within a few weeks. <u>The second step was to find a property for the trade up</u>.

Finding a qualifying replacement property to complete the trade is usually the hardest part of a tax-deferred exchange. Clyde Cournale Realty in San Francisco had a listing on a suitable nine-unit "fixer upper" building. The motivated seller accepted my exchange purchase offer, contingent on the simultaneous trade and "cash out" sale to the waiting buyer already arranged by Skyline Realty.

All went very well. I got my simultaneous tax-deferred trade up, the seller of the nine units got his taxable cash, and the buyer of my three units got a good starter investment property. Everybody was happy, even Uncle Sam who received his capital gain tax on the sale of the nine-unit building.

<u>TODAY'S "STARKER EXCHANGES" ARE MUCH EASIER</u>. Although simultaneous exchanges still occur, if this same tax-deferred exchange occurred today it would be much easier. <u>The reason is Internal Revenue Code 1031(a)(3), the so-called Starker exchange rules</u>. Starker exchanges have now become the "standard" type of realty exchange. Even large corporations use Starker exchanges to avoid capital gain tax on profitable real estate sales and property replacements.

For those not familiar with the late T.J. Starker and his very important contribution to tax-deferred exchange, I'll give you the short version of his story. He owned some Oregon timberland which Crown-Zellerbach Corporation wanted to acquire at a huge capital gain profit to Starker.

He deeded his land to C-Z which credited Starker with the sales price, plus a 6% "growth factor" until he could find suitable qualifying "like kind" property to acquire with that money for completion of the exchange. After Starker acquired other property he liked with the funds C-Z was holding for him, the IRS said he owed tax on his profit because it wasn't a direct simultaneous exchange (as I did with my three units for the nine units).

Starker paid the disputed tax (to stop the running of interest) and then sued the IRS in U.S. District Court for a tax refund. He won! But the IRS appealed to the Ninth Circuit U.S. Court of Appeals. The IRS lost!

The happy result for realty investors is we now have IRC 1031(a)(3) which was enacted by Congress in 1984, establishing the Starker exchange rules. You can read the fascinating case at ***Starker v. U.S.*****, 602 Fed.2d 1341.** Thanks to T.J. Starker, today's tax-deferred "delayed" exchanges are downright easy.

The first step is to find a buyer for the investment or business property you want to sell. *When a buyer makes a suitable purchase offer, be sure the sales proceeds will be held by a qualified third-party intermediary beyond your constructive receipt.* If you receive the sales cash, or have the right to do so, that ruins your tax-deferred exchange. *Leaving the sales proceeds in escrow means you have a right to receive the cash so the sale is disqualified as a Starker tax-deferred exchange.*

The second step, when the sale of your old investment or business property closes, is to be sure the sales proceeds go directly to a qualified third-party intermediary, such as a bank trust department which specializes in Starker tax-deferred exchanges, or to the exchange subsidiary which most large title companies now can provide.

There are also independent exchange facilitator companies. If you select one of these independents, be sure your funds are well-protected. Some of these small companies have gone bankrupt, causing loss of tax-deferred exchanges for their clients (see ***In re Sale Guaranty Corporation*****, 220 B.R. 600** for a classic example what can go wrong for exchangers when the third-party intermediary accommodator goes broke).

The third step is to use the cash from your property sale, being held beyond your constructive receipt by the qualified third-party intermediary or accommodator, to purchase the suitable replacement property to complete the tax-deferred exchange.

There are several very important rules for designating this replacement property:

1—The replacement property must be designated in writing to the exchange accommodator intermediary within 45 days after the sale of your old property closes;

2—Not more than three possible properties can be designated (however, you can withdraw one possible property from your list and substitute another property during the 45 days);

3—As an alternative, you can designate more than three properties if their total fair market value does not exceed 200% of the fair market value of the relinquished property;

4—IRC Regulation 1.1031(k-1(e)) allows designating within the 45 days a replacement property which includes a contract to construct, build, install, manufacture, develop, or improve

property to be acquired. However, a property already-owned by the exchanger cannot qualify under this Regulation.

Within 180 days following the sale of the old property held for investment or business use, the acquisition must be completed. No time extension is allowed by the tax statute or regulations.

To avoid being under extreme time pressure to meet the 45-day and 180-day deadlines, one method is to delay the closing date for the sale of your old investment or business property. A second method is to rent the old property to the prospective buyer on a lease-option to be exercised on a date to be designated by the seller after a suitable replacement property is under purchase contract.

MISTAKES TO AVOID. If you are within the 180-day replacement period, *don't* file your income tax return for the tax year in which you sold your old property. *The reason is filing your income tax return for the prior year automatically stops the running of the 180-day replacement period.*

> **EXAMPLE:** That happened in the tax case of ***Christensen,*** **T.C. Memo 1996-254** where the sale of a large apartment building closed on December 22, giving Orville and Helen Christensen until June 21 of the following tax year to close their purchase of a qualifying replacement property to complete their Starker tax-deferred exchange. The sales proceeds were held by a qualified intermediary accommodator. However, the Christensens made the costly mistake of filing their income tax returns on April 15, thus automatically terminating their 180-day replacement period! Instead, they should have filed for a tax filing automatic extension and waited to file their tax returns for the prior year after June 21 when they acquired the replacement property. As a result of their error, they had to pay $220,039 capital gain tax on their apartment building sale because they were disqualified from making a tax-deferred Starker exchange. Wouldn't you think investors with that much profit could afford to hire a competent tax adviser?

Another mistake to avoid is to correctly designate the qualifying replacement property within the 45-days after the completed sale of the old property.

> **EXAMPLE:** On August 22, 1989 David and Naomi Dobrich of Danville, CA sold 117 acres of their Antioch, CA land for $3,969,000. Their adjusted cost basis was only $281,825 and their capital gain was $3,687,175. During the 45 days after the sale title transfer, the Dobrichs designated 10 properties to their accommodator as possible replacements. But none was acquired. In February 1990, within the 180-day replacement period, the Dobrichs acquired a Pleasant Hill, CA shopping center and a rental home in Zephyr Cove, NV. When the IRS audited their tax returns, it was discovered the purchase agreements had been re-dated and letters were back-dated to September 1989 indicating intent to buy the two properties which had not been designated within the 45-day replacement period. Under a plea-bargain agreement with the U.S. Department of Justice, David Dobrich pled guilty to two counts of causing delivery of false documents to the IRS. The U.S. Tax Court denied the Starker tax-

deferred exchange benefits because the third-party accommodator constructively received the sales funds on behalf of the taxpayers. The court imposed a 75% fraud penalty for tax underpayment by intentionally evading the capital gains tax. The total tax owed was $3,889,571 including penalties and interest because the exchangers didn't meet the 45-day notification rule – ***Dobrich*, T.C. Memo 1997-477.**

STARKER "REVERSE EXCHANGES" ARE NOW LEGAL, BUT THEY AREN'T EASY. A major problem with Starker exchanges is the replacement property is often found before the old property is sold. For years, real estate and tax attorneys debated whether or not Starker "reverse exchanges" could qualify for tax deferral. The solution was to "tie up" the property to be acquired, such as with a purchase option, a lease-option, or a long-term purchase contract with a delayed closing date. These are still excellent methods to use.

But in October 2000, Internal Revenue Bulletin 2000-40, modified by Revenue Procedure 2000-37 (26 CFR 1.1031 (a)-1), available at the IRS website www.irs.gov explained the new IRS "safe harbor" rules when a qualifying replacement property is located before the old property in a Starker exchange is sold.

Title to the property to be acquired to complete the exchange may now be taken and held by a third-party accommodator who temporarily holds title to the replacement property (called "parking" by the IRS) if that entity is considered its owner "for federal income tax purposes."

That means, for example, if a toxic waste dump is discovered on the property, the third-party title holder will be responsible for its cleanup. But the exchanger can agree to indemnify the third-party exchange accommodator against liability while holding title. The maximum "parking" time limit for either the old or new property is 180 days. During that time, the exchanger can lease but not hold title to the parked property.

Two approved methods for Starker reverse exchange tax deferral. The IRS has approved at least two reverse exchange methods:

1—The old property can be "relinquished" to the third-party accommodator in trade for the already-acquired reverse exchange replacement property; then the old relinquished property can be transferred by the accommodator to its waiting buyer, or

2—The third-party accommodator can transfer title to the already-acquired replacement property to the exchanger who then transfers title to the old property to the exchange accommodator to hold the title until that property is sold.

But the IRS Bulletin adds "Further, the Service (IRS) recognizes that 'parking' transactions can be accomplished outside of the safe harbor provided in this revenue procedure...the Service (IRS) will not challenge the qualification of either the 'replacement property' or 'relinquished property' for purposes of IRC 1031." That statement might become important if the IRS contests a reverse exchange.

The IRS recently issued Revenue Procedure 2004-51 which says the safe harbor rules do not apply after July 20, 2004 to property held by an exchange accommodator if that property was previously owned by the exchanger. To illustrate, a reverse exchange cannot be used to avoid the barrier to re-acquiring your own property after making improvements, such as new construction. In other words, you can't exchange with yourself.

<u>Written reverse exchange agreement is required within five days</u>. The IRS rules require the taxpayer and the exchange accommodator title holder to enter into a written contract within five days after the transfer of title for either the old or replacement property to the third-party accommodator. The contract must state title is held for the benefit of the exchanger to facilitate a tax-deferred IRC 1031 reverse exchange under Revenue Procedure 2000-37 which requires reporting the transaction to the IRS.

<u>The exchanger has 45 days after the third-party accommodator acquires title to the replacement property to identify which currently-owned property the exchanger will be relinquishing</u>. Up to 180 days is then allowed after the accommodator acquires title to the replacement property for the exchanger to sell the old relinquished property.

Obviously, being an accommodator in a reverse exchange is not a job for amateurs – be sure to select a firm which specializes in Starker delayed exchanges. Incidentally, your attorney, CPA, real estate agent, or any other entity with which you have done business within the last two years is *not* eligible to be your qualified third-party intermediary accommodator.

<u>NEW RULE FOR CONVERTING PROPERTY ACQUIRED IN A TAX-DEFERRED EXCHANGE TO YOUR PERSONAL RESIDENCE</u>. Effective October 22, 2004, President Bush signed the American Jobs Creation Act of 2004. It amended Internal Revenue Code 121(d)(10) – the principal residence sale tax exemption rule – to read:

> **PROPERTY ACQUIRED IN LIKE-KIND EXCHANGE. If a taxpayer acquired property in an exchange to which IRC 1031 applied, subsection (a) shall not apply to the sale or exchange of such property if it occurs during the 5-year period beginning with the date of the acquisition of such property.**

In plain English, that means after October 22, 2004, taxpayers who acquire an investment or business property in an IRC 1031 "like kind" tax-deferred exchange, such as a rental house, must <u>own</u> it at least five years before they can sell it and claim the IRC 121 principal residence sale exemption up to $250,000 (up to $500,000 for a qualified married couple if both spouses meet the 24 out of 60 month principal residence occupancy test).

<u>Of course, at the time of acquisition the residence must be a rental property to qualify for the IRC 1031 tax-deferred exchange</u>. Most tax advisers suggest renting the property at least six to 12 months to show rental intent at the time of the exchange. The IRS has no official position on minimum rental time after the exchange.

This is still a great method for "freeing" what would otherwise be a taxable capital gain upon the sale of an investment or business property. *The only change made by new IRC*

121(d)(10) is the property must be held at least five years before its sale can qualify for the IRC 121 principal residence sale exemptions (after at least 24 months of the owner's principal residence occupancy during the 60 months before sale).

> **EXAMPLE:** Suppose you own an investment or business property in which you would have a $400,000 capital gain if you sell it. But you don't want to pyramid your estate by trading up to a more valuable investment property. You would like to eventually liquidate your profit without paying a huge capital gain tax. Virtually the only way to do that is to make a Starker tax-deferred exchange for a residence rental property where you would like to move in for at least 24 of the 60 months before selling it and claiming the $250,000 IRC 121 principal residence sale exemption (up to $500,000 for a qualified married couple filing jointly). The new tax law change simply says you must hold title to the acquired residence at least five years before qualifying for IRC 121 (but you only need live in it two of those five years as your principal residence).

Another method can be used by homeowners who have more than a $250,000 or $500,000 capital gain who want to sell their current principal residence and acquire investment or business property.

> **EXAMPLE:** Your principal residence where you have lived many years has greatly appreciated in market value. If you sell it, your net profit (capital gain) will be $600,000. That is not an unusual situation in many communities. If you are single, you can claim a $250,000 exemption by using IRC 121 (or up to $500,000 if you are married and your spouse also meets the two out of last five years principal residence occupancy test). But the excess capital gain exceeding your IRC 121 exemption will be taxed. However, if you want to escape the capital gain tax completely, you can convert your home into a rental property before selling it, and then make a Starker tax-deferred exchange for another qualifying investment or business property of equal or greater cost and equity. To answer your obvious question how long must your home be rented to tenants before qualifying for a tax-deferred exchange, the official IRS answer is "Nobody knows for sure." Most tax advisers suggest renting your former principal residence at least six to 12 months to show rental intent before exchanging it for a qualifying "like kind" investment or business property to defer tax on 100% of your profit.

I.R.S. APPROVES TAX-DEFERRED EXCHANGES INTO TENANCY IN COMMON (TIC) INVESTMENT PROPERTIES. That brings us to another method of avoiding tax when disposing of a property held for investment or use in a trade or business. It involves making a Starker exchange of your current rental or investment property for a tenant in common (TIC) share in a commercial property.

> **EXAMPLE:** Several years ago my friends, Andy and Dory, sold their California rental house for a large capital gain profit. As they were getting on in years and no longer enjoyed managing "tenants and toilets," they made a Starker tax-deferred exchange into a tenant in common (TIC) master-lease trip net (NNN) share in an Applebee's Restaurant in Kentucky! All they have to do now is cash their rent checks they receive from the

property management company. Their full investment, without tax erosion, keeps working for them, producing income and tax benefits while they enjoy retirement.

The IRS approved this technique in Revenue Procedure 2002-22. As a general rule, there cannot be more than 35 TIC co-owners. They must agree unanimously on major sale, lease, and finance decisions. TIC shares can be sold or transferred. However, investors are cautioned of possible pitfalls, such as acquiring an interest in an over-priced commercial property being sold by inexperienced marketers to seek quick profits in a new real estate investment area.

At the recent 2004 National Association of Realtors convention in Orlando, I was amazed at the many exhibit booths of firms hyping their TIC investments to show Realtors how to find TIC replacement property quickly to complete Starker tax-deferred exchanges. I'm sure most of those firms are reputable. But I fear some quick-buck shysters might get into the TIC business, so please be very careful before buying to check out both the TIC property (especially the quality of the TIC tenants and their leases) and the experience and reputation of the promoter.

For More Information. As always, consultation with your tax adviser, attorney or other professional is advised before proceeding with a tax-deferred exchange. This special report explains only the basic tax-deferred exchange highlights. An excellent website with lots of more-detailed information is www.1031.us. It is sponsored by Realty Exchange Corporation, a third-party intermediary accommodator. Be sure to check their superb "like-kind exchange analysis" calculator form which compares results of selling and paying capital gain tax verses exchanging a property.

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