

## *The Estate Planning Advisor*

### **Saving Taxes With 1031 Exchanges**

**By Richard J. Shapiro, J.D.**

The run-up in real estate prices in the Hudson Valley over the past five years has increased the wealth of many people – at least on paper. Many folks who would like to cash out their equity are hesitant to do so because of the capital gains consequences of a sale. At current Federal and State rates, approximately twenty percent of the capital gain must be sacrificed for taxes.

Fortunately, the tax code grants every individual a \$250,000 exemption from capital gains tax, with married couples able to shelter \$500,000 of gain. Unfortunately, the same exemptions do not apply to non-residential real estate.

But there are potential solutions. Presently, we have three primary mechanisms for deferring or eliminating capital gains taxes upon the sale of non-residential real estate: 1031 Exchanges, Private Annuity Trusts and Charitable Trusts.

1031 exchanges are so named based on the section of the Internal Revenue Code authorizing their use. While there are a number of nuances to a 1031 exchange, the basic mechanism works as follows: the real property sales agreement should contain specific provisions indicating that the transaction is intended to be part of a 1031 exchange. As usual, the down payment can be retained by Seller's attorney in escrow pending the closing. However, at closing all the net sale proceeds (i.e., after payment of closing costs) must be made payable to a designated 1031 "Qualified Intermediary" and cannot go into the Seller's pocket. There are a number of national and local companies who specialize in serving as Qualified Intermediary, and many local title companies and attorneys can fill this role as well.

Within 45 days after closing on the sale, the seller *must* identify to the QI up to three potential replacement properties. Failure to meet this deadline will be fatal to the 1031 process. Assuming a timely identification has been made, the seller has up to 180 days from the date of closing (*not* from the date of identification) to *close* on the purchaser of the replacement property(ies). At that closing the QI will pay the purchase price from the escrowed proceeds and the transaction will be deemed completed. So long as the proper formalities of the 1031 requirements are satisfied, no capital gains will be recognized, except to the extent that funds remain from the first sale in excess of the cost of the replacement property.

Keep in mind that if the replacement property is later sold and a 1031 (or other tax planning device) is not utilized, the gain will be recognized upon the future sale. However, if the replacement property (or subsequent replacement properties) is held until the property owner's death, under current law the beneficiaries will receive a full "step-

up” in basis to the fair market value of the property as of the property owner’s date of death. This scenario can result in the complete elimination of substantial gains on real property.

What if the client does not wish to continue actively managing real estate but also does not wish to recognize the gain? There are a number of well-respected companies that specialize in “pooling” sales proceeds from multiple clients and investing in large commercial projects such as shopping centers and office buildings. In these structures, known as “tenant-in-common” arrangements, the investment company manages the project, with each owner receiving income from the investment without any management responsibilities. These arrangements may not be suitable for everyone, but they are often worth a look for many clients.

In the next two issues of the *Senior Gazette* I will be reviewing the other primary additional capital gains tax planning devices, Private Annuity Trusts and Charitable Remainder Trusts.

---

*Richard J. Shapiro is a partner with the Middletown law firm of Blustein, Shapiro & Rich, LLP. Mr. Shapiro is a member of the National Network of Estate Planning Attorneys, the National Academy of Elder Law Attorneys, the New York State Bar Association (Trusts and Estates and Elder Law Sections), and the Hudson Valley Estate Planning Council. He can be reached at (845) 692-0011 or at [rshapiro@mid-hudsonlaw.com](mailto:rshapiro@mid-hudsonlaw.com). The information in this article is for general information purposes only and is not, nor is it intended to be, legal advice*