

Using IRS Section 1031 to defer taxes and to build your net worth.
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As many real estate and hotel investors have discovered (the hard way), a completed sale of investment property is a taxable event. On the other hand, most investors have heard of the benefits contained in Section 1031 of the Internal Revenue Code. In spite of the widespread knowledge pertaining to “1031 exchanges”, I am often amazed at how many transactions are entered into and closed without the proper provisions to accommodate the tax-deferred exchange. Within our brokerage practice, we routinely advise our clients to ask their attorney to insert a 1031 provision within all sales contracts, even if they are unaware of their intentions pertaining to the use of their proceeds at sale. Taxpayers who continually use the 1031 provisions properly, may defer taxes on their gain indefinitely. Taking the tax deferral process a step further and as long as the “stepped-up” basis rules are in effect, the taxes will be permanently deferred upon death of the taxpayer. (This is the rare time that the term “tax free” exchange is accurate). This article is not intended to be a comprehensive treatise on the complicated provisions contained within the Section. However, descriptions of requirements and considerations within Section 1031 may provide stimulus for further investigation and use of its provisions.

1. Always give thought to using a “1031” paragraph in your purchase agreement. It documents your intentions pertaining to the exchange and the use of the proceeds. There is no “penalty”, other than taxes, if you do not complete the exchange.
2. In order to qualify for tax deferral the taxpayer cannot experience “constructive receipt” of the proceeds. In the escrow documents, taxpayers should disclose that they have no rights to receive, pledge, borrow or otherwise obtain benefits of the cash or cash equivalent at closing. The proceeds must be held by a qualified intermediary or in a qualified escrow or trust account.
3. After the sale of the taxpayers property and he/she wishes to complete a tax deferred exchange, the tax payer has 45 days after close of escrow to identify the replacement property(s). The code allows the taxpayer to identify (a) up to a maximum of three (3) properties, irrespective of value, or (b) any number of properties as long as their aggregate (combined) fair market value (FMV) does not exceed 200 percent of the aggregate FMV of all relinquished properties. The document identifying the replacement property (document identification) should be held in escrow by the qualified intermediary, title company or escrow agent.
4. In order to qualify for tax deferral under the provisions of the code, the taxpayer must acquire (close) each replacement property by the earlier of midnight of the 180th day following the closing date of the relinquished property or the due date for the taxpayers income tax return for the taxable year in which the relinquished property was sold.
5. Investors are often aware that tax deferral exists for the sale of their real estate, but are often confused as to what constitutes “like kind” property. The regulations

require that, in order to qualify for tax deferral under Section 1031, the “like kind” property must be held for “productive use in a trade or business” or “for investment”. For example, a hotel does not necessarily have to be exchanged for another hotel, although that is the most frequent exchange in our practice. Sellers of investment property are often surprised that the “like kind” provisions do not restrict them to the same type of property in order to complete a qualified exchange.

The following are examples of “exchanges” that would qualify for tax deferral:

1. A portfolio of duplexes for a hotel
2. A shopping center for vacant land or commercial lots
3. A ranch for an apartment complex
4. A hotel for a net leased property
5. Tenancy –in-common (TIC) interests will qualify for tax deferral.

On the other hand, the following **will not** qualify:

1. Stocks, bonds or notes
2. Mortgages or other indebtedness
3. Partnership interests
4. Personal property for real estate

In closing, the foregoing provides sellers and buyers a glimpse of the possibilities available to them to defer taxes on the sale of their property. On the other hand, I have just scratched the surface with regards to the complexity of Section 1031. If you wish to defer taxes on the sale of your hotel, you should contact legal counsel, **before** you enter into any agreements to sell. Hopefully, you will seek out those attorneys skilled in hotel real estate and with expertise in Section 1031.

Mr. Jaynes is a co founding member of Leisure Real Estate Advisors. Since its inception in 1998, Leisure Real Estate Advisors has become one of the national leaders in hotel sales.