MORTGAGE CORNER

Defer taxes on sale of property with a 1031 exchange

By Ilyce Glink and Samuel J. Tamkin, Tribune Content Agency, Real Estate Matters

Q: We are going to sell a townhouse that we have owned for about 25 years in a desirable area of town. We rented it to tenants during that entire time and have never lived in the house.

The house belonged to my mother, who gave it to us when she moved. At that time, the transfer appraisal value was $100,000, but now these townhouses are selling from $215,000 to $225,000. We intend to renovate the kitchen, paint all rooms, and install engineered hardwood floors on the first level.

We were told by our accountant that we would have to pay about $50,000 in income taxes when we sell the property. First, is that true? And second, is there a way to avoid some of these taxes? My wife and I are retired and receive Social Security.

A: You've owned a property for about 25 years and that property has appreciated substantially. Now you want to sell it and not pay federal income taxes on the sale. Over the 25 years that you've owned the property, you've probably depreciated the property almost completely. That means that over the last 25 years you might have received tax benefits from the IRS that allowed you to reduce your federal income taxes over those years.

When you sell the property, the IRS will want to recover the depreciation at a rate of about 25 percent and will tax the capital gains on the sale of the property at a rate of up to 20 percent plus the 3.8 percent Medicare tax enacted several years ago (as of this writing, the tax has not been rescinded). Using your numbers, we estimate that you'd have a profit of about $125,000; the $50,000 federal tax seems about right.

(Remember, that because your mother gave you the property, you actually received it at her cost basis, which is the price she paid, plus the costs of purchase and any material or structural improvements she made. If she paid a very low price for the property and never made any improvements to it, that could change the amount of taxes you'd owe.)

If you need the cash, you might have to just sell the home, pay the taxes and keep the cash proceeds.

But if you don't need the cash and want to sell, you can defer paying all taxes by undertaking a 1031 exchange. These exchanges are sometimes referred to as a Starker Exchange or a like-kind exchange. In these exchanges, you'd sell your current property and have to buy one or more replacement properties whose value equaled or exceeded the sales price of the property you sold.

At the time of the closing or settlement (and not a minute later) you'd have to set up the exchange with a company that handles tax-deferred exchanges (also known as a qualified intermediary). Please make sure that you find a reputable company that has been in existence for quite some time, will hold your funds in a separate account, and has all funds in its possession insured for your benefit. If the intermediary goes out of business, you don't want to lose your money and have to pay taxes on the profit from the sale without having any proceeds to show for the sale.

You'd have 45 days from closing (settlement) to designate one or more replacement properties (with a limit on how many you designate, as you can't use a list of many) and then close on the replacement property no later than 180 days following the closing (settlement) of the sale of your current property. If you do that, you buy new properties and defer paying any federal income taxes on the sale. But all of your cash from the sale would also get invested in the replacement properties.

If you are tired of managing your property as a rental, you can use the 1031 exchange to invest your proceeds into a different investment real estate property that might require less hands-on work, but the money you make out of the investment may be less and your entire investment could be at risk.

You might consider selling the home on an installment basis. That is to say, you sell it on contract with the buyer paying you monthly over time. You'll get income from the sale but you'll pay federal income taxes on a much smaller amount over time. Given that you are on Social Security and your income might be low on the tax scale, you might benefit from lower capital gains tax rates selling over time. But, you'll have to talk to your accountant to see if either the like-kind exchange or the installment contract would be good for you.

If you decide to go with a like-kind exchange or installment contract, we'd also suggest you use a real estate attorney to help you out with the paperwork and to make sure your interests are protected.