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Housing Counsel: IRS Monitoring Starker Exchange

by Benny L. Kass

Question: What can you do with the investment property you have obtained by way of a Starker exchange? Everyone I know that has done an exchange has not, in my opinion, kept the property as investment.

Three individual examples:

1. A person buys a house as a second home and his lawyer tells him that as long as he runs an ad in the paper showing that he tried to rent the property he can satisfy the IRS questions. He has used the house as a second home the entire time he has owned it. He also runs the "for sale" ad in an out of the area newspaper and no one has called.
2. Another couple bought their house as an Exchange property and has used it as a second home too. They run a small business, so to show that the property is rented they just rent it to themselves under the name of the business.
3. Another person bought a house and while he uses the property on a regular basis, he gets a friend to write him rent checks so he can show he rented it. He uses the property more than 14 days per year and lets relatives use it during the year as well.

Does the IRS check on these transactions. If all we have to do is fill out paperwork for a Section 1031 exchange, we all might as well say we did an exchange and not pay taxes on our second homes? Is it so easy to fool the IRS?

Answer: Very interesting. My quick answer: "Do not pass Go; go directly to Jail."

I do not know how many 1031 exchanges the IRS audits every year, although I do know that any such exchange is subject to review by an IRS employee.

I also know that if these friends and neighbors ever get caught, they will be in serious legal and financial trouble.

Starker exchanges have become very popular in recent years, especially as real estate prices have been escalating. A Starker exchange is authorized by Section 1031 of the Internal Revenue Code, and is also referred to as a 1031 exchange. Some people mistakenly call it a "tax free" exchange, but that is not exactly correct.

You cannot exchange your personal residence. There are other benefits available, such as the up to \$500,000 total exclusion of profits for couples filing a joint tax return, and who have lived and owned their house for a period of 2 out of the five years before it is sold (if you file a separate tax return, you are only eligible for up to \$250,000 exclusion of profit).

If you own investment property, and sell it, you will have to pay 15 percent to the IRS on any gain (profit) you have made. In addition, depending on what State your property is located, you may have to pay a similar State capital gains tax.

But, if you enter into a 1031 exchange, and if the replacement property is equal to or greater than the sales price of the relinquished property, no tax is immediately due. The tax basis of the relinquished property becomes the basis for the replacement property.

Let's take this example: You purchased a small investment property in the 1970's for \$100,000. You have rented it out since taking ownership. Now, you are prepared to sell it for \$900,000.

Eliminating such items as depreciation recapture, real estate commissions, and closing costs, in our example you will make a profit of \$800,000. Under current federal law, you will have to pay the IRS \$120,000, and whatever tax the state will hit you with.

However, you have decided to buy another piece of investment property for \$1,000,000. If you meet the stringent time limitations required for a successful 1031 exchange -- 45 days from settlement to identify the replacement property (or properties) and 180 days from settlement to actually take title -- you will defer having to pay this large sum of money. The basis of this new property for which you paid \$1 million will be the basis of the old relinquished property.

Does this mean that you get off scott free and avoid taxes altogether? Not necessarily. If, down the road, you sell the new property for even the same price that you paid for it, you will then have to pay the full capital gains on the profit. In our case, profit is the difference between the tax basis of the property and what it sold for.

Obviously, there will be people who will try to trick the IRS into believing that the replacement property is really investment, when in fact it is being used personally by the exchanger.

What constitutes investment property? Here, another section of the IRS CODE (§280A) comes into play, since this limits the deductibility of interest, taxes, losses and other expenses by a taxpayer whose use is less than 14 days per year or 10 percent of the number of days that the property is rented.

Your friends and neighbors have obviously done their homework. They know that their property loses its investment status if it is personally used for more than 14 days per year. So they have concocted schemes to try to keep the replacement property eligible for 1031 purposes.

I am not aware of any cases or IRS rulings to give us guidance. What is clear is that if you use the vacation home for more than 14 days per year, it will not be considered "investment property," and thus is not eligible for a Starker exchange.

Your friends and neighbors are defrauding the government, and -- if caught -- can face serious criminal fraud charges. Is it worth the risk? I think not.

My best suggestion: If you plan to use the vacation home as the relinquished property, do not use it personally for at least two years, and two tax returns. The IRS has adopted what is known as the "old and cold" rule. If you engage in a transaction for the purpose of avoiding the payment of tax, and the transaction occurred more than two years ago, the IRS will generally not pursue the matter.

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