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Selling real estate without paying taxes?

By T. Craig Lewis III

As many timberland owners know, the value of rural property has increased substantially over the past few years.

Trillions of dollars have been released into the economy due to COVID and other federal government stimulus programs. As a result, wealthy individuals have bid up the price of rural property for their own recreational use and for investment purposes.

Some timberland owners have contemplated selling their rural properties to take advantage of these extraordinary, inflationary prices. However, many landowners have a very low tax cost basis in their property and are reluctant to sell due to the large capital gains tax they would have to pay Uncle Sam and Louisiana.

Tax-Advantaged Solution

A tax law provision known as a Section 1031 Exchange allows a real estate owner who holds property for business or investment purposes to exchange their property for other “Like-Kind” property and defer

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paying any tax on the Exchange.

The use of the word “Exchange” is somewhat confusing. In most 1031 Exchange

transactions, it is actually a sale of your property followed at a later date by your purchase of another property. You can Exchange (sell) any investment or business real estate and Exchange (purchase) any other type of business or investment real estate.

An example would be timberland property exchanged for some type of income producing rental property such as a multi-family apartment complex, a self-storage property, or even a mineral royalty interest, etc. These properties could be acquired and professionally managed inside a Delaware Statutory Trust (DST).

The DST is created by billion-dollar real estate sponsors and management companies. A DST permits fractional ownership where multiple investors can share ownership in a single property or a portfolio of properties, which qualifies as replacement property as part of an investor’s 1031 Exchange transaction. A major advantage of purchasing a DST interest is there are no management responsibilities for the investor.

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 Exchange Process Utilizing
 DST Replacement Property

1. Exchanger (Owner) sells his property, known as the “Relinquished Property,” and proceeds are escrowed with a Qualified Intermediary (QI).

2. QI, through a written agreement with the Investor, transfers funds for the purchase of the “Replacement Property.”

3. Exchanger (Owner) receives a beneficial fractional interest in a DST. The DST Owner will begin to receive monthly income from the DST and will receive his or her share of the sales proceeds when the property is sold in the future.

A Qualified Intermediary is an independent third party, institutional entity, that facilitates Section 1031 Tax Deferred Exchanges. The QI receives and holds the proceeds from the sale of the Relinquished Property in a Trust or Escrow Account to ensure the Exchanger (owner) never has actual or constructive receipt of the sales proceeds which would trigger capital gains consequences.

Why Exchange? — A Case Study

The benefit of a Section 1031 tax deferred exchange can be substantial. Let’s look at a hypothetical example:

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Show Me the Money — Hypothetical Comparison

Comparison	Sell	Exchange
Sales Price	\$1,200,000	\$1,200,000
Tax Liability	\$280,000	\$0
Net Proceeds for Reinvestment	\$920,000	\$1,200,000
Total Cash Flow for 10 years - 5% annually	\$460,000	\$600,000
Value of the Investment at the end of 10 Years - 3% annually	\$1,236,000	\$1,612,000
TOTAL Cash Flow And Future Value	\$1,696,000	\$2,212,000

Source: Lewis Financial Group LLC

Hypothetical Assumptions

- Tax Cost Basis \$200,000
- 28 percent Tax Rate (Fed 20 percent + 3.8 percent; State 4.25 percent)
- 5 percent Annual Cash Flow is Spent
- 3 percent Annual Compound Growth of Net Proceeds is in addition to Cash Flow
- Reinvestment is in the Same DST for an “Apples-to-Apples Comparison”

Jane and Tom Smith, both age 70, own a 400-acre tract of rural land with a young stand of planted timber, as well as some hardwoods. A rural real estate broker has a wealthy client who is looking to purchase a rural property fairly close to town to use for hunting and other recreational purposes. The broker’s client made a very attractive \$1.2 million offer for the Smiths’ property. The Smiths have decided to accept this offer. This money will provide them with additional retirement funds to be able to travel.

The Smiths have asked a professional who specializes in evaluating and acquiring DST investment offerings to research and present them with available replacement property choices. The Smiths have

decided to purchase a DST interest in a 96 percent occupied, 200-unit luxury apartment complex, built in 2020. It is managed by one of the nation’s leading real estate investment companies that has been in business for 25 years. They could have also chosen to purchase multiple fractional interest investments in several different types of DST properties for diversification purposes.

Let’s compare The Smiths selling their property and paying federal and state taxes to selling their property and utilizing a 1031 tax deferred exchange into the above hypothetical DST investment.

The tables above on this page show this hypothetical comparison.

In summary the Smith’s at the end of 10

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years:

- Deferred \$280,000 of taxes.
- Received \$140,000 more cash flow from their investment to pay for travel expenses (\$600,000 vs. \$460,000).
- The future value of their investment at the end of 10 years was \$376,000 greater (\$1,612,000 vs \$1,236,000).
- The total cash flow and future value of their investment at the end of 10 years was \$516,000 greater (\$2,212,000 - \$1,696,000).
- The Smith's children and/or grandchildren will inherit a professionally managed, income producing real estate investment with a step-up in date of death value for tax cost basis purposes at the time of the Smiths' deaths. Therefore, the \$280,000 of original deferred tax was completely avoided, and never had to be paid, even when this property is sold by the children and/or grandchildren. This assumes the Smiths continued to utilize a 1031 exchange for subsequent property sales and purchases while they were living.

Bottom Line

The undeniable numbers tell the story of the substantial monetary benefits achieved by utilizing a 1031 tax deferred exchange versus selling and paying taxes. The Smiths could have utilized a partial 1031 exchange, and chosen to receive part cash, which they would have to pay taxes on, and utilize the remaining portion of the sales proceeds to purchase 1031 replacement property. It is very important to keep in mind that there are other rules and deadlines that need to be closely followed to qualify sales and purchase transactions as a valid 1031 Exchange. For additional useful information see "1031 Exchange Do's and Don'ts" at www.lewisfinancialgroup.com.

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