

# Property exchanges showing signs of decline

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One of the greatest tax strategies in the real estate industry is use of the 1031 exchange. Internal Revenue Code Section 1031 allows real estate investors the opportunity to defer capital gain on a sale of real property by investing the proceeds into another property.



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This strategy has been so popular in the last 10 years that facilitating these transactions has become big business. With these facilitators making it easy to exchange, coupled with the boom in the real estate market, record numbers of taxpayers elected to forgo cashing in on sales of property and, instead, elected to invest in more real estate.

Lately, however, there has been a cooling down of exchange activity. The reasons vary among taxpayers.

One reason for the slump in the market is the overall condition of the real estate industry. Sure, the housing market is going through a sharp correction, but commercial properties are still selling at high levels.

Investors like to sell their properties at the height of the cycle, but it's difficult to buy real estate during that same cycle without overpaying. Some investors fall into the trap of forcing themselves on real property purchases just to defer the tax but are stuck with an investment that offers them too low a return on their investment.

Also, higher sale prices make it harder to find replacement property of equal value. In some cases, taxpayers may be better off paying the tax and using the balance of the proceeds elsewhere.

Another reason investors choose to opt out of exchanging is to diversify their assets. Real estate values have increased so much over the last few years that such investments represent too large a share of an investor's portfo-

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lio. This makes many investors uncomfortable. With the stock market performing better than earlier this decade, they are lured back to the equities market that so disappointed them years before.

With private-equity and hedge funds available to more people, investors have more investment options.

Diversification is also key for estate planning. Having a large portion of an estate tied up in nonliquid assets such as real property can be problematic if the estate doesn't have the cash to pay the taxes on the value of the property. As the baby boomers get older, estate planners will be advising clients to divest themselves of real estate instead of exchanging and acquiring more.

The political climate is also affecting the use of exchanges. The tax rates on capital gains are the lowest in recent history. Most everyone agrees that rates will not get any lower. President Bush will probably veto any increase in the rate that Congress may pass. After the 2008 elections there could be a good chance that rates could increase. Many taxpayers feel it is unwise to defer capital gains into years where the tax rate could be higher. In anticipation of this, they are electing to keep the proceeds and pay the tax now.

Is this a wise move? It depends on

how much the rate increases and how much gain you have in the asset. If the tax rate increases only slightly and your tax gain is most of the value of your asset, you still may be better off going with the exchange scenario.

With the current real estate market conditions, favorable performance in the stock market and pending tax legislation, will exchanges become extinct? Of course not. It's still one of the few great opportunities in the tax code that allows taxpayers to increase their wealth while deferring taxes on the gain. Even in a seller's market there are great buying opportunities; investors just have to work harder to find them.

Capital-gain tax rates may increase, but it still may be economically better to defer paying the tax and use the monies for long-term investment in real estate.

In any case, each taxpayer and each transaction is different and one answer does not fit everyone or every transaction. A qualified tax professional that's also familiar with your personal strategic goals is key to helping you decide whether to exchange and defer, or cash in and invest elsewhere.

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