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All good things do not have to come to an end

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I have been told again and again that all good things must come to an end. In sports we have seen the demise of many dynasties:

• The Pittsburgh Steelers from the mid 70s

• The New York Islanders in the mid 80s

• The Chicago Bulls in the mid 90s and yes,

• Even the Yankees of the late 90s.

In corporate America, we have seen the rise and fall of many companies and who could ever forget the collapse of the internet sector. In Hollywood, who could ever forget the last episode of Sienfeld.

However, our tax laws have provided us with a methodology to indefinitely defer the capital gain (appreciation) on the sale of property held for productive use in a trade/business or for investment purposes. I think we can all agree that this is a "good thing." The vehicle to defer the capital gain is known in tax circles as a "1031 Exchange" (see Section 1031 of the Internal Revenue Code).

We have been flooded with information on this topic and the use of this capital gain shelter has grown at astonishing rates over the last decade. Without getting into the detailed intricacies of this process, since such detail should be the job of your tax professional, the following must occur to defer the entire capital gain:

Our tax laws have provided us with a methodology to indefinitely defer the capital gain (appreciation) on the sale of property held for productive use in a trade/business or for investment purposes.

1. All of the proceeds of the sale must be used to buy "like-kind" property.

2. The replacement property should be identified within 45 days.

3. The exchange must be completed by the earlier of the due date of the taxpayer's tax return (including extension - only if filed) or 180 days.

The presence of a capital gain is not mandatory for a 1031 Exchange. You can defer a capital loss but I don't know many individuals that would want to defer a capital loss these days.

Let's take a look at the benefit of a 1031 Exchange with the following example:

You purchase a building for $780,000 and own it for 15 years during which you take $300,000 worth of straight-line depreciation leaving you with an adjusted basis (book value) of $480,000 ($780,000 less $300,000 in depreciation). The property which is now "free and clear" is sold for $2 million resulting in a capital gain of $1.52 million ($2 million less $480,000). Even though the current federal capital gain tax rate on assets held for more than one year is only 15%, the amount of capital gain associated with depreciation is taxed at 25%. In addition, state and local taxes could be an additional 10%. The total capital gain tax on this example would be $300,000 @ 25% for depreciation recapture plus $1.22 million @ 15% for federal taxes plus $1.52 million @ 10% for state and local taxes resulting in total capital gain tax of $410,000 or an effective capital gain tax rate of almost 27%.

As mentioned earlier, to defer the entire capital gain, all of the proceeds of the sale must be used to buy "like-kind" property, however, you can refinance the new property immediately after the purchase which in essence places the proceeds back in your financial control.

The major question is what ever happens to the deferred gain. Obviously, once the replacement property is sold with no additional replacement property being purchased within the allotted timeframe, you will have to pay capital gain tax on the entire deferred amount. However, if you take advantage of this law to the fullest, the entire gain can be infinitely deferred. Such can be achieved by transferring the 1031 Exchange property to a family member or very lucky friend through your estate. The individual receiving this gift/inheritance will receive the property at the "stepped-up basis" or in plain English, the current market value.

With proper estate tax planning surrounding a 1031 exchange, "a good thing will never come to an end."

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