**DEFERRING TAX ON SALE OF REAL ESTATE AND OTHER INVESTMENT PROPERTY**

**By Shon C. Robben**

If possible, we would all like to avert having to pay capital gains tax when we sell investment real property. Section 1031 of the federal tax code does not allow a taxpayer to completely avoid capital gains tax for these sales, but it does allow a taxpayer to indefinitely defer paying capital gains tax on such transactions.

In 1997, Congress passed the Taxpayer Relief Act which reduced the maximum long-term capital gain rates from 28% to 20%. That rate reduction eased the tax burden for persons wishing to sell investment properties subject to long-term capital gains. However, despite the reduction in tax rates, many people still face significant capital gains tax when selling investment and business properties.

Section 1031 of the tax code allows a taxpayer to defer capital gains tax through what is called a Atax-deferred exchange. Assets which are eligible for this transaction include capital assets used in a trade or business. The property usually used in these transactions is real property held for investment purposes or used in a trade or business. Although real property is most often used for a tax-deferred exchange, personal property items which are capital assets used in a trade or business may also be eligible. However, certain property is excluded from eligibility for tax-deferred exchange treatment, including securities, partnership interests and inventories.

To be eligible for a tax deferred exchange, the taxpayer must reinvest the proceeds from the property being sold into another property which will be held for investment purposes or used in a trade or business. The property being sold is referred to as the Arelinquished property and the property being acquired is the Areplacement property. In order to defer the capital gains tax, the relinquished and replacement properties must be considered like kind properties. For instance, if a taxpayer is selling real property, he or she must replace it with real property. If a taxpayer is selling a certain type of personal property, he or she must replace it with a similar type of personal property.

In the event the transaction qualifies as a tax-deferred exchange, the taxpayer's tax basis from the relinquished property will be transferred to the replacement property. That basis will be carried over in the new property until the replacement property is sold by the taxpayer. At the time of such sale, the taxpayer could then either conduct another tax-deferred exchange or simply sell the property and pay the capital gains tax. In the event the replacement property stays in the person's family and is passed to the taxpayer's heirs after death, the real property may then receive a stepped-up basis allowing the property to be sold by the heirs without any capital gains or other tax on the property.

A tax-deferred exchange can be established in a variety of ways, including straight exchanges of property between taxpayers, exchanges involving three or more parties, and exchanges involving the use of a qualified intermediary.

There are a variety of rules and regulations that must be met for a taxpayer to qualify for a tax-deferred exchange. These include specific time limits for locating and purchasing replacement properties as well as certain restrictions for sales of property involving family members. Provided that all of the proper procedures and regulations are followed for these transactions, tax-deferred exchanges can provide a significant tax savings for sales of investment and business properties.