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# COLORADO REAL ESTATE JOURNAL BUYERS INVESTMENT GUIDE

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SECTION CC

## Using 1031s to transfer wealth tax-free

A 1031 exchange is a technique that investors commonly use to transfer property tax-free. However, our sophisticated investors are using 1031 exchanges to transfer large amounts of wealth, tax-free to their children.

This is how it works:

Mom and Dad own a building that is worth \$100,000 and is free and clear. Finding a new building worth \$150,000 they sell their old building and use a 1031 exchange to buy an undivided two-thirds interest in the new building for cash. Their children buy the other undivided one-third interest.

A year or two later they sell the building for \$250,000 of which \$166,667 is the parents' two-thirds share with the balance of \$83,333 belonging to the children. Both the parents and the children do 1031 exchanges and buy a new property for \$400,000 of which \$166,667 (or 42 percent) is the parents, and the balance of \$233,333 (or 58 percent) belongs to the chil-



**Gary Gorman**  
Manager, Professional  
Exchange  
Accommodators LLC,  
Englewood

dren. If this building is then sold for \$500,000 and a new building purchased for \$600,000 the parents 42 percent share of the sale of the old building (\$210,000) would be transferred tax-free to the new building, resulting in a 35 percent share with the children's share now 65 percent and worth \$390,000.

If the parents are in the upper federal estate tax bracket of 55 percent, their estate tax savings would be at least \$214,500, and probably much more depending on the estate taxes payable to the state that they live in. Depending on the cash flow need or the parents and the kids, there is ample opportunity to direct the cash flow from the properties over the years using "management fees."

Another technique that we have used to assist clients in transferring wealth is to have the parents buy individual replacement properties with the intent to transfer the property to the children upon the parents' death.

To illustrate, assume that elderly parents sell bare land for \$900,000. They have three adult children and plan to leave their estate equally to the kids. If they sell the land outright, state and federal income taxes on the gain will probably eat up about one-third since their basis in the land is almost nothing. As an alternative, they could do a 1031 exchange, sell the land, and buy three commercial buildings for \$300,000 each as the replacement property – on for each of the kids.

Since the intent is that the kids will inherit the property, each of the children could be actively involved in the purchase on one of the properties, with the intent that that kid would inherit that property.

For example, if one of the children is a high-income doc-

tor, he may choose bare land for his investment in order to avoid further taxable income. The low-income teacher child, meanwhile, may choose a property with a high level of income and cash flow.

An added benefit to the parents is this situation is that their income certainly would increase since they are moving their investment from bare land to income-producing commercial property. And, if any of their children need help with money while the parents are alive, they could pay them a management fee to care for that child's property. This would be tax deductible to the parents.

These are just two examples how our clients have used 1031 exchanges to transfer wealth to their heirs. While there are many more, time and a good plan will obviously let you move a great amount of wealth to your heirs using simple 1031 exchange techniques. As always, when you have a complicated exchange transaction, a knowledgeable exchange professional is key. ▲