

UNDERSTANDING THE 1031 TAX EXCHANGE

I've been told more than once that, in life, two things are inevitable: death and taxes. Well, I'm here to tell you that one of the two can be deferred. No, I'm sorry to say, I don't have the elixir for the fountain of youth, but I can tell you how some savvy investors defer capital gains taxes and preserve assets through a little tax rule found in the Internal Revenue Code called the 1031 exchange. This powerful tax code section can help you to purchase "like-kind" property and avoid loss of assets resulting from selling your property and currently paying capital gains taxes.

IRC 1031 has been around since 1921, so it is not new, but it is extremely relevant to today's real estate marketplace. It is a rule that can assist landlords and investment professionals to increase their investment potential and preserve equity. These are called tax-deferred exchanges: invested money you may think you would lose to tax in a sale, but which can be deferred and reinvested into a more valuable property.

IRC 1031, when used correctly, can help you to exchange the property you now own to a property you desire to own. This may be done through a third party facilitator. Before you go to closing on the first, or "exit", property, you may have a "Qualified Intermediary", a person who draws the appropriate documentation to process the 1031 exchange. This intermediary is in control of the proceeds from the exit property until the target property is identified, and then disperses those funds at the closing of the purchase of the new, or "target", property. You, as the beneficiary, never have possession of any of the proceeds from the sale. If at any time you take possession of any of these proceeds, you may have to pay capital gains tax.

So, you may be wondering why you would consider a 1031 exchange. There are some complex rules and technicalities involved, but 1031 exchanges may just open up opportunities you haven't yet considered.

The number one reason to use a 1031 exchange is to **preserve equity**. You can defer 100% of all federal and state capital gains taxes, considering such transaction to be a "tax-free" loan on deferred taxes until you sell the property for cash. Some investors continue rolling over these gains to build wealth.

The second reason is to **leverage** equity into a more valuable property, one that may have a greater cash flow, or one that has depreciation moving from a property that has been fully depreciated.

The third advantage is to **diversify**. Using the 1031 exchange, you can sell a property in one city to purchase property in another, or perhaps buy more than one property in two different cities. This is a popular way to acquire vacation properties.

An additional reason is for **management relief**; for instance, selling several single family homes to buy an apartment building with an onsite manager to oversee day-to-day operations, or becoming involved with investment groups in which there are no individual management

responsibilities.

Furthermore, the 1031 exchange may be utilized for **estate planning**. If you own an apartment building you can exchange it in for single family properties, so in the event of your passing, you can bequest separate properties to family members.

How much can a 1031 exchange save you? Let's use a simple example: you sell an investment property. In one example, you sell and take the cash, and in the other example, you sell and choose to use a 1031 exchange.

You sell an apartment building for \$400,000, which you originally purchased for \$200,000. You have depreciated the property by 75%, and the outstanding debt is \$200,000. The capital gain is roughly \$350,000. What would you have left to reinvest?

CAPITAL GAINS PAID ON SALE

\$150,000 (depreciation)	X 25% (tax rate)	=	\$37,500
<u>\$200,000</u> (capital gain)	X 20% (tax rate)	=	<u>\$30,000</u>
\$350,000	Total Taxes Paid:		\$67,000

SALE VS. EXCHANGE

	<u>Sale</u>	<u>Exchange</u>
Equity	\$200,000	\$200,000
Capital Gain Tax	(\$ 67,000)	0
Cash to Reinvest	\$133,000	\$200,000

75% LOAN TO VALUE

New Property Amount	\$532,000	\$800,000
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As with all good things, in order to enjoy the benefit of this rule, there are some rules you must follow.

1. A 1031 exchange must be "like-kind" property. But you can exchange a single family rental for an apartment or commercial rental. This rule is much more flexible than it sounds.
2. Once you close on your "exit" property you have 45 days to identify your "target" property.
3. You must close on the target property within 180 days of the closing of the exit property. There are some rules about filing tax returns during this process. Check with your tax professional to see if you need to file before you close on the target property.
4. The exchange must be facilitated by an IRS-approved "Qualified Intermediary".
5. The target property(ies) must be worth more than the exit property(ies). You must buy a property for more than the one you are selling.

The key here is to ask yourself a lot of questions about your situation. First, ask yourself questions such as:

- What it is that I hope to achieve with my investment property?
- What type of property would better my position as an investor?
- If I keep my current property, what will the value be in 10 years?
- What would my investment (equity) be worth in 10 years if I owned a better piece of property?

Of course, your investment would be worth more if you had a more desirable property. Using equity in a current property to buy up is one of the best ways to build equity faster, leveraging your equity while using lenders' money to capitalize on appreciation. If property values go up 10% in a year, which investment would you rather have?

Being a smart investor is the reason you purchased investment property to begin with. Now you have another tool to make your investment work harder and wiser.

I hope that you have a better understanding of the 1031 exchange process. Please note that it is always wise to consult with your tax professional before making investment decisions.

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Footnote:

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