Investments:

1031 Exchanges – A Review

By: Christopher Miller

Since I help investors with 1031 exchanges for a living, I spend a lot of time talking about them. Every year or two, I'll write a "refresher" article that covers the basics of 1031 exchanges. If you are familiar with the process of such an exchange, this month's article will still be worth a read. I still learn new things about the 1031 exchange frequently – and you can, too!

A Problem that 1031 Exchanges Can Help With - Taxes

Real Estate investors buy and manage their properties because they seek some (or all three) of these things: 1. Income from the properties, 2. Tax shelter of that income through depreciation and/or 3. A gain upon the sale of the property. The IRS has ways to tax you on all three of these benefits.

How can the IRS tax your tax savings? They do eventually when you sell your building. Every year, when you complete your tax return, your real estate depreciation allows you to lower your taxable income from your property. As part of your tax records, the IRS "runs a tab" for you called "accumulated depreciation:" this is the sum of all the depreciation that you took during your ownership period. Every year, the depreciation taken gets added to your tab. When a property is sold, the IRS will want a tax payment on your capital gains AND on your accumulated depreciation. Whichever state you live in will charge a tax both of these as well.

For capital gains tax: the good news is this means you earned a profit on your property. The bad news is that this tax paid will erode your principal and leave you less money to reinvest for income and growth potential.

For accumulated depreciation tax: the good news is that the rate you "pay back the IRS" is usually less (currently 25% Federal + whatever your state charges) than ordinary income tax rates – so you saved money. The bad news is that money was saved in the past – you are not paying that tax with dollars that are in your hands now. This is why some investors that say "capital gains is only 20% - I'll just pay the tax," can then be unpleasantly surprised when their tax bill is 50% (or higher) of their sales proceeds.

What is a 1031 Exchange, and How Can it Help?

A Section 1031 Exchange is a process that the IRS allows investor to use that, when executed cor-

Please turn to page 32

Christopher Miller is a Managing Director with Specialized Wealth Management in Tustin, California and specializes in tax-advantaged investments including 1031 replacement properties. Chris' real estate experience includes work in commercial appraisal, in institutional acquisitions for a national real estate syndicator, and as an advisor helping clients through over two hundred 1031 exchanges. Chris has been featured as an expert in several industry publications, and on television, and earned an MBA emphasizing Real Estate Finance from the University of Southern California. Call him toll-free at (877) 313 – 1868.

Continued from page 30

rectly, will postpone all of these taxes until the next time you sell the property. An investor who completes repeated 1031 exchanges, (every time he sells, he exchanges), can potentially defer these taxes forever – since they are wiped out by the stepped up basis your heirs receive upon your death.

Like Kind Properties

In order to complete an exchange, the IRS says that you must replace your relinquished (sold) property with a replacement property that is like kind. Many investors interpret "like kind" too narrowly and think this means apartment building for more apartments. It is actually a broad description that includes any real property. The IRS' web site lists investment properties , fractional interests in properties or even energy royalty rights as qualifying real property for exchanges.

Time Requirements

An investor completed a 1031 exchange must use an accommodator to hold his funds between the downleg sale of the relinquished property and the upleg purchase of its replacement. In addition; investors will have 45 days to identify some properties they may buy as replacements. This list of "may purchase" properties can be changed any time before the 45th day. After the 45th day deadline passes; this list cannot be changed. Your replacement property must be a property on that list, or you will not receive tax deferral through the 1031 exchange. Note that: if an investor closes on a property during their 45 day window, they do not need to identify anything.

After the 45th day of an exchange, an investor then has 135 more days (or 180 days total) to close on one, some or all of their identified properties. These days are all set in stone as of your closing date: if one of them falls on a weekend, or on Christmas Day, that is still your deadline.

Spend All of Your Equity and Replace All of Your Debt

If I sold an apartment building for $1.5 million, paid $100,000 of sales costs and paid off a $500,000 loan to give me $900,000 of equity in my accommodator's account, the IRS says that I need to spend all of that $900,000 of equity and assume a loan of at least $500,000 on my replacement property to defer my taxes completely. Although I can not spend $500,000 of equity, assume a $900,000 loan, and pocket $400,000 "tax-free," the rules would allow me to add $500,000 of "fresh cash" to my equity and buy a $1.4 million property with no debt.

The 1031 Exchange to Keep More of What You Earned – And Keep it Working for You!

By using a 1031 exchange, you will not need to send a big chunk of your hard earned investment proceeds off to the government and can exchange it into another income generating piece of property. By investing 100% of your proceeds rather than the 60, 50 or 40 percent that is left, you can keep more money working for you – with the potential for greater income and/or gains.

1031 Exchanges are complicated, but easy to understand once you have done your homework. If you have any questions about them, please call my office toll-free at (877) 313-1868 and ask.

This does not constitute an offer to buy or sell any security. Investments in securities are not suitable for all investors. Investment in any security may involve a high degree of risk and investors should review all "Risk Factors" before investing. Investors should perform their own due diligence before considering any investment. Past performance and/or forward looking statements are never an assurance of future results. Securities offered through Sandlapper