Investments:

Properly Identifying Properties for Your 1031 Exchange

I have been writing monthly real estate articles for almost 10 years now, and have been able to examine a variety of topics such as 1031 Exchanges, real estate analysis, and economics. More recently, I have devoted some articles towards more "back to basics" topics. After all, anything related to taxes is certain to be complicated, and we can all benefit from a refresher every so often.

This month, we will talk about how to property identify properties for a 1031 Exchange.[1] A property owner selling investment property can delay, (potentially forever), paying capital gains and accumulated depreciation taxes on his proceeds if he completes a 1031 Exchange. The 1031 Exchange involves exchanging the property you sold – your *downleg* property, with another property – your *upleg* purchase. The IRS guidelines for a completely tax deferred exchange

1 https://firstexchange.com/content/top-ten-identification-rules-1031-exchanges

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prescribe that A. An investor can defer these taxes by purchasing a *replacement property.* B. The investor must use a *qualified intermediary* or *accommodator* to receive the sales proceeds from escrow, and hold them until that replacement property is purchased. C. From the sales closing date, the exchanger has 45 days to identify to his accommodator some properties that he might buy, then 135 more days (or 180 days total) to close on one, some or all of them.

This month's article will discuss the rules behind properly identifying your potential replacement properties. There are three rules to keep in mind, and you'll need to pick one to identify with.

The Three Property Rule

This rule is fairly simple to understand, and means what it says: With it, an investor can identify three potential replacement properties *with no limit to their value*. The investor can close on one, some or all of these properties to complete a tax-deferred exchange.

The 200% Rule

With the second and third rule, things start getting tricky. The 200% rule says that we can identify as many properties as we want, and close on one or some of them, provided that the total value of the identified properties is less than 200% of the fair market value (FMV) of our downleg *property.* What does that mean? Let's say that we sold 4 units that we owned free and clear for $1 million.[2] The IRS would then call $1 million the FMV of that property. Using the 200% rule, we can identify as many properties as we want *provided that the total value of these properties is less than $2 million.* ($1 million X 200% = $2 million.) If I wanted to buy four $600,000 properties, each with a $250,000 down payment and a $350,000 loan, this would put my total value at $2.4 million: over the 200% rule. Does this mean that I cannot buy these 4 properties then? Well; not necessarily, as we will learn from the next rule.

The 95% Rule

This rule is actually a "part B" of the 200% rule, but I treat it as a third to simplify the explanation; and also because it functions differently. The 200% Rules states that an investor can identify as many properties as he wants – regardless of value – as long as he closes on 95% of them. A more practical summary of this rule is "you can identify as many properties as you want – provided that you close on all of them." (you would need to identify 20 properties in order to buy 19 and hit that magical 95% number.) The investor from the 200% rule above can use this rule to buy 4 properties valued at $2.4 million: provided that he closes on *all four of those properties.*

Some Accommodators Have Different Requirements

During my 16 years in the 1031 Exchange business, I have seen that many accommodators interpret these IRS requirements differently. They all agree on the above 3 rules, but will treat the identification process differently concerning *exactly how we identify these properties.*

Some accommodators will want the property addresses only, while others will want the dollar values of the properties identified. (Even in cases where the Three Property Rule is used – where the dollar value, in my opinion, is irrelevant.) Many of my clients buy, as replacement properties, partial property interests in Delaware Statuatory Trusts (DSTs.) Some accommodators will accept just the DST name for identification: Sample Texas Apartments, DST, for example, while others will insist on seeing the property address.

Often, my DST investors can close their upleg purchase, and complete their 1031 Exchange, within days of their downleg sale closing. By doing this, they can begin receiving their monthly distribution checks right away without an interruption of cash flow. Some accommodators I work with say that an investor closing within the 45 day identification window does not need to identify at all. Other accommodators will insist that he does.

Fortunately, these differing 1031 requirements are easy to address – they only require communication with your accommodator. (I will often speak to accommodators on my client's behalf to property identify properties.)

The 1031 Exchange – To Keep Your Equity Growing.

The IRS, through the 1031 Exchange, makes it possible for us to keep the potential income and growth from the equity we have spent years building up. The 1031 Exchange allows us to, using the example above, re-invest our full $1,000,000 rather than pay taxes first and re-invest $700,000. By paying taxes first, I'd need to earn 43% on day one just to break even! The $1 million route is the one I'd choose and you probably feel the same way, too.

The IRS doesn't want to make it that easy for us, though, and puts up a few roadblocks to "trap" a few investors so they can collect taxes. Without these identification limits an investor could, in theory, identify the phone book and buy one of those properties to complete an exchange. This would result in more

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2 To keep things simple, my examples omit transaction costs.

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completed exchanges – which would be bad for the IRS. (And certainly bad for accommodators who will need to keep thousands of phone books on their shelves.)

With a little bit of work, though, we can potentially reap big rewards. That's why we bought investment real estate in the first place – right? These rules may seem very complicated, but I deal with them every day and have gotten quite good at explaining them. If you have any questions, please call my office at (877) 313-1868. I'll be happy to help.

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What Is.. Your Investment Property's *Cash on Cash Return*?

Would you put your money in a bank account at a low interest rate? Probably not, but many investors are doing just that with their investment properties. Although property values have increased dramatically, income has not for many investors.

Try This- Calculate your Cash on Cash return.

Yearly Income - _______(subtract) Expenses ______(subtract) loan payments _______

= Annual Cash Flow ______________

Now, estimate your property's value___________ (subtract) Loan Balance__________

= Your Equity Value ______________

Now, divide your Annual Cash Flow by your equity value, and you get your

Cash on Cash Return % _____________ .

Want to increase your properties' income potential?
Call Chris Miller at **877-313-1868** today!