Investments:

Buy Down the Debt Requirement for Your 1031 Exchange

Many of my readers are familiar with the "debt replacement requirement" in 1031 exchanges. To achieve a completely tax-deferred 1031 exchange, an investor must buy a replacement property using **A.** all of the equity he received from his sale and **B.** assume a loan of equal or greater value. So a landlord who sold a $1,000,000 apartment building and paid off a $250,000 loan must spent all of his $750,000 ($1 million - $250,000) of equity and assume a loan of at least $250,000 when buying his replacement property.

There are other ways to complete a 1031 exchange, and this article will discuss them. I often have clients who are selling properties with higher leverage amounts. Perhaps, for example, the sold that $1 million building but paid off a $750,000 loan – leaving them with $250,000 of equity and a 75% ($750,000 / $1,000,000) *loan to value ratio*, or LTV, to cover. Let's review three potential solutions for this investor:

Solution 1: Find Another Highly Leveraged Property.

This investor can, of course, find another highly leverage property in order to complete his exchange. This would mean finding another $1 million property, putting $250,000 down and assuming a loan to complete the purchase and a completely tax-deferred exchange.

This investor may not be comfortable with this level of debt, or be able to arrange a loan with such a large LTV ratio. He has two more options to consider:

Solution 2: Exchange Into A Lower Leveraged Property To Defer As Much Tax As You Can, Pay Taxes On The Rest.

This investor may find a $750,000 property that he likes, and arrange a $500,000 loan to go with his $250,000 down payment for a more manageable 66% Loan to Value. This will create $250,000 of "debt boot," ($750,000 loan needed - $500,000 loan received). He has deferred as much of the taxes as he can, and will just settle up the rest next year when he files his tax return. By doing this "partial exchange," he'll only need to pay 25% of the amount due had he not done an exchange at all.

Solution 3: Add Cash To "Buy Down" The Debt In Your 1031 Exchange.

My investors don't like the idea of losing their hard-earned principal to taxes. Fortunately for us; there is another option that I call "buying down your

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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.

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debt."

Investors can still achieve a completely tax-deferred exchange by adding cash to their exchange. In the above example, the $250,000 "boot" shortfall can be addressed by a supplement of "new cash." Fortunately, due to the power of leverage, an investor need not pay that entire amount out of pocket.

Let's say that our investor sold his $1,000,000 property, paid off his $750,000 loan, and is left with $250,000 of equity. He has found a $1 million replacement property and arranged a loan of $650,000, for a 65% LTV. Once he adds his $250,000 to the $650,000 loan, he'll need to add $100,000 more of "fresh cash" to complete this exchange. This investor has successfully deferred all his taxes through a 1031 exchange, and used his $100,000 of extra equity to purchase $285,714 of additional property – for more potential income, growth, and tax savings through depreciation.

In our last example, the investor was able to "buy down" his potential $250,000 taxable debt boot by adding just $100,000 of fresh cash to his 1031 exchange. Depending on factors like where he lives and the amount of time he owned the property, the $100,000 could be close to the tax he would have owed from the partial exchange. Would you rather give your hard-earned money to the government or reinvest it?

I help my clients with their 1031 exchanges. If you have any questions, please call at (877) 313-1868.

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