FINANCIAL ADVISORY

Seek Potentially Greater Income and Lower Taxes Through a 1031 Exchange: A Case Study

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Many of my clients have owned real estate for a long time and enjoy great income from their holdings. Their depreciation deductions, however, are either based on a much lower value or are gone completely. This month, I will talk about how you can possibly gain more depreciation income through selling your property and accomplishing a completely tax deferred 1031 Exchange.

BUYING NEW BASIS WITH LEVERAGE AND CREATING NEW DEDUCTIONS

The investor in our case study purchased his property in 1980 for $200,000. Today, that property is worth $1.3 million, and the loan he purchased the property with has been fully paid off. At a 4% CAP Rate (common here in Los Angeles and Orange Counties), his Net Operating Income is $52,000 annually – fully taxable.

If that investor sold his building and bought a moderately-leveraged (say, 52% loan-to-value, or a 48% down payment) replacement investment, he could buy a $2.7 million building. The IRS would consider the amount of the property funded by debt ($2.7 million X 52% = $1.4 million) to be new basis. If we assign 80% of this value to improvements and depreciate it over 27.5 years, this gives us an annual depreciation deduction of $50,909.

APPLY THAT NEW DEDUCTION AGAINST POTENTIALLY HIGHER INCOME OUT OF STATE

If we were able to use positive leverage to buy a property out of state and earn a potential 5% cash on cash return on that $1.3 million of equity, we could generate $65,000 per year of net income. When we subtract our new $50,909 deduction from that, the IRS will only see $14,091 of taxable income. Under this scenario, our investor increased his spendable income by 28% while decreasing his taxable income by 72%! Would you be interested in the potential for a decent increase of income with a substantial decrease in taxes?

MORE APPRECIATION POTENTIAL THROUGH MODERATE LEVERAGE

Us real estate investors understand the power of leverage. The investor in our example saw his property value increase from $200,000 to $1.3 million in just under 40 years – an increase of 650%. Our investor, however, bought this property

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with a 20% down payment. Therefore, he turned $40,000 into $1.3 million over the same time period – that is an increase of 3250%! That doesn't even take into account the income that he has enjoyed over the years. By replacing our paid-off property with a moderately-leveraged one, we are giving ourselves a chance to enjoy more appreciation over our ownership period.

A TAX DEFERRED IS A TAX DISAPPEARED AT YOUR DEATH

I have heard investors tell me that their heirs will need to pay back their deferred taxes upon their death. Under the current tax code, this is not correct – all these accumulated depreciation and capital gains taxes will disappear when your heirs get a stepped-up basis upon your passing. As I often say – when you die and go to taxpayer heaven, your taxes die with you. Why not maximize your income and minimize your taxes until then?

We all began buying real estate to enjoy the potential for tax-advantaged income and appreciation of our investments. Does the potential to increase both of these interest you? My toll-free number is (877) 313-1868.

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- There is no guarantee that any strategy will be successful or achieve investment objectives;
- Potential for property value loss – All real estate investments have the potential to lose value during the life of the investments;
- Change of tax status – The income stream and depreciation schedule for any investment property may affect the property owner's income bracket and/or tax status. An unfavorable tax ruling may cancel deferral of capital gains and result in immediate tax liabilities;
- Potential for foreclosure – All financed real estate investments have potential for foreclosure;
- Illiquidity – Because 1031 Exchanges are commonly offered through private placement offerings and are illiquid securities. There is no secondary market for these investments.
- Reduction or Elimination of Monthly Cash Flow Distributions – Like any investment in real estate, if a property unexpectedly loses tenants or sustains substantial damage, there is potential for suspension of cash flow distributions;
- Impact of fees/expenses – Costs associated with the transaction may impact investors' returns and may outweigh the tax benefits

Scenarios provided herein are provided merely to illustrate mathematical principals and are not a guarantee of performance.