Investments:

The Basics –

Save Taxes on Your Property Sale with a 1031 Exchange

Many of my 1031 Exchange Articles recently have covered what I call "graduate level" information. I think that a "back to basics" article could benefit some investors who aren't yet aware of the money they could save through a 1031 exchange. Thus, a broad introduction will be our focus this month.

What Tax Problem Does a 1031 Exchange Solve?

Real estate investors can enjoy many benefits from owning their properties. First – investment properties provide the potential for monthly income. Second – over the years, investment properties may increase in value: representing a "growing savings account" of sorts for their owners. Third – Thanks to a wonderful rule known as the "depreciation deduction," investors have been able to defer taxes on some or all of the income they receive from the property's operation. You'll notice that I emphasized the word defer. You'll see why in a second.

Let's say that I bought a house in Orange County for $140,000 back in 1984, and sold the property this year for $650,000. If the property is fully paid off, I'll pocket approximately $510,000 in profit, right?

Well, that's a before tax profit. We all expect some taxes on our earnings, but many investors are surprised to learn the full extent of them – often after it's too late to do anything about it. Let's add up the bill now: (These are necessarily estimates. Your taxes may be different and can be accurately estimated by the person who files your annual returns.)

First – and this is the tax we are all expecting – the IRS will want capital gains tax of 20% on our profit – the bracket you'll be in with a gain of this size. 20% of $510,000 is $102,000. We're not done yet, though: the state you live in will want their share. Here in California, you will fall into the 9.3% tax bracket. This tax (because you'll step through 5 other brackets to get there), will add $42,383 to your bill.

We're not done yet: and this is where I'll explain that defer term that I highlighted earlier. When you write off depreciation, (and it is mandatory that you do), that tax doesn't disappear – it is merely deferred. The government will seek to collect this deferred tax if you sell your property without a 1031 exchange. Using our example, this investor fully depreciated the $140,000 home during his 33 years of ownership. Because land value can not be depreciated, let's say that he estimated the property's value to be 25% land and 75% improvements. This means that he wrote off 75% x $140,000 = $105,000 of value during the ownership period. The tax man is ready to collect now: The IRS will want 25% on his accumulated depreciation, or $26,250. The state of California's 9.3% will be an additional $9,765.

Lastly; there is a 3.8% Medicare, or "Obamacare tax." This adds a 3.8% charge on everything, so that math is ($510,000 + 105,000) x 3.8% = $23,370. The end result is that your $510,000 windfall is reduced to $510,000 - $102,000 - $42,383 - $26,250 - $9,765 - $23,370 = $306,232. That's quite a bit lower, right? If you want to reinvest this money, you'll need to earn 10.7% per year for the next 5 years in order to get

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back to even. Fortunately, the 1031 exchange is a way that you can keep all of your money working for you by deferring those taxes so you can reinvest the entire $510,000.

How Does a 1031 Exchange Solve This Problem?

By using a 1031 Exchange, an investor simply defers all of these taxes to the next time he sells the property. (He could potentially defer the tax forever – we'll talk about that in this article's conclusion.) An investor who follows the 1031 exchange guidelines can take that $510,000 of profits and re-invest it into another piece of investment property. This way, he keeps all of his principal "in the game" earning income and growing for him.

1031 Exchange Rules

Next, we'll go briefly though the steps that you'll need to follow in order to take advantage of these tax benefits with a 1031 exchange.

Use an Accommodator

In a 1031 Exchange, an investor must use an accommodator as a financial intermediary between his sale and next purchase. An accommodator works like an escrow company – although it is very important that they are not your escrow company. The accommodator will receive the funds from your sale, and hold them while awaiting your instructions on what to buy.

Follow Time Requirements

From the date of your property sale, you have 45 days to identify some properties that you may buy, and 135 more days (or 180 days total) to close on one, some or all of them. One can identify using the 3-property rule, the 200% rule or the 95% rule. (An in-depth explanation of these rules is beyond the space limitations of this article. Please call my office for a more complete review)

Buy Like Kind Property

1031 Exchange regulations state that an investor must replace his sold property with one of like kind. Many investors read this term narrowly, and think that like kind means "apartments for apartments." Like kind is actually a broad term that includes all investment real estate. It is possible to 1031 exchange an airplane for another airplane or a business for another – one just can't trade investment real estate for either of those. So you can trade your apartments for a retail property, a vacant lot or even a partial interest in a portfolio of NNN leased buildings. (Provided that portfolio is structured properly.)

By using a 1031 exchange, an investor can defer these accrued taxes and keep all of his money working for him. Would you rather have the income that $300,000 can generate or the income from $500,000? Additionally, as I hinted previously, it is possible to defer these taxes forever – by continuing to complete 1031 exchanges throughout your lifetime. Upon an investor's death, these taxes will disappear and his heirs will receive what is called a stepped-up basis. This means that they could sell his properties the next day and pay zero capital gains or accumulated depreciation tax.

The 1031 exchange offers real estate investors a powerful tool to save on taxes. Many of my investors plan to complete 1031 exchanges for the rest of their lives. In this way, they defer, defer, defer and die. Upon their death, they go to "taxpayer heaven," and their taxes die with them – leaving more for their heirs.

If you have any questions, please call Chris Miller at (877) 313-1868.

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