FINANCIAL ADVISORY

Use "Combo Exchanges" to Save Taxes:

Meeting 1031 Exchange Debt Requirement

BY CHRISTOPHER MILLER, MBA
SPECIALIZED WEALTH MANAGEMENT

HAPPY NEW YEAR!

I have completed over five hundred and twenty five 1031 Exchanges for my clients since 2003, and sometimes we'll run into a situation where an investor needs more leverage than he could get with his first choice of replacement property. For many years, I have been using what I call "combo exchanges" to solve this issue. This month, I will show how this process can help save you taxes the next time you're doing an exchange.

A REVIEW OF 1031 EXCHANGE REQUIREMENTS

To briefly review 1031 Exchange rules, the IRS says that – in order to perform a completely tax deferred 1031 Exchange, an investor must replace all the Equity he receives as proceeds from the sale and replace all the Debt he paid off during the sale. This means that an investor selling a $1.5 million property, paying off a $1 million loan, and receiving (to his accommodator account) $500,000 of proceeds MUST invest all his $500,000 of proceeds and assume a new loan of at least $1 million in order to achieve that completely tax deferred exchange.

A partially tax deferred exchange is possible: If the investor above bought a $900,000 property with $400,000 of Equity and assumed a $500,000 loan, he would create ($500,000 - $400,000) $100,000 of "Equity Boot" and ($1,000,000 - $500,000) $500,000 of "Debt Boot." ("Boot" is a term used to describe taxable portions of a real estate transaction.) This investor would defer taxes on ($400,000 + $500,000) $900,000 (what he bought) of his sale and owe taxes on ($100,000 + $500,000) $600,000 of Boot.

As an advisor, I like to help my clients avoid paying taxes when possible. How would I address the above issue? Let's look at the two most common ways that I see this topic arise:

ISSUE 1 - INVESTOR WANTS TO TAKE SOME MONEY OFF THE TABLE

Let's say that my client sold his property for $950,000, paid off a $450,000 loan, and has $500,000 of proceeds. Following the guidelines above, he needs to match these numbers in his replacement property, so he needs to find a property he can leverage at ($450,000 / $950,000) a 47.4%, or Loan to Value or LTV. This is a moderate amount of leverage that isn't hard to find from a lender, or when buying partial interest properties.

Let's imagine, however, that this client wants to take $200,000 out of his exchange, pay the taxes, and

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Christopher Miller is a Managing Director with Specialized Wealth Management 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 five hundred twenty five 1031 Exchanges. Chris has been featured as an expert in several industry publications and on television and earned an undergraduate business degree and an MBA emphasizing Real Estate Finance from the University of Southern California. Chris began his real estate career in 1998. Call him toll-free at (877) 313 – 1868.

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renovate his house. Now he has $300,000 of Equity left to replace with a $450,000 loan. This gives him a required LTV of $450,000/$750,000 or 60% - harder to find in tough lending environments.

ISSUE 2 – INVESTOR WANTS TO BUY A LOWER-LEVERAGED PROPERTY

We'll use the same sale numbers above to illustrate this example. This investor sold his $950,000 property, paid off his $450,000 loan, has $500,000 of Equity to reinvest and is looking for at least a 47.4% loan to value ratio. This investor, however, has fallen in love with a partial interest replacement property in Texas that has an in-place loan at a 35% LTV. This means his $500,000 of Equity will only assume $269,231 of loan. This will create ($450,000 required - $269,231 assumed) $130,769 of Debt Boot.

WHY DEBT BOOT CAN BE A PROBLEM – IT IS "THE MOST EXPENSIVE KIND OF BOOT."

I always say that Debt Boot is the most expensive kind of Boot. This is because investor A above took $200,000 of cash out of his exchange – so he can use some of this money to pay his taxes. Investor B, however, spent all the Equity in his exchange. He will need to pay his taxes with cash from another source. I need to come up with money from somewhere else – THAT's why it's "the most expensive kind of Boot."

THE SOLUTION – A COMBO EXCHANGE

My solution to the above problems involves completing what I call a "combo exchange." For our second investor above, he doesn't have to forego buying the property he fell in love with. We'll just put $360,000 of his Equity into this property. At a 35% LTV, this gives him $193,846 of loan. Now he has $140,000 of Equity remaining and ($450,000-$193,846) $256,154 of loan to replace. We can find a property with 65% leverage to buy with his $140,000 and assume $260,000 of Debt. We have therefore met all the requirements for a completely tax deferred 1031 Exchange. Rather than paying taxes, this investor has kept all his Equity working for him, maintained his full income and growth potential, and deferred (potentially forever) his capital gains and accumulated depreciation taxes.

Such a combination will also work well for the investor in our first example. Remember that, of his $500,000 Equity proceeds, he took $200,000 for himself, and is left with $300,000 to exchange and $450,000 of Debt to replace. Let's say that he also loves that Texas property leveraged at 35%. We can put $180,000 of his Equity into that property – his share of the loan will then be $96,923. This means that we have $120,000 of Equity and ($450,000 - $96,923) $353,077 of Debt remaining to replace in his exchange. (For a 74.6% LTV). If we put his $120,000 of Equity into a property leveraged at 75%, (a 25% down payment), we will then assume $360,000 of Debt – just above our investor's requirement. We have therefore allowed him to take cash out of the exchange and pay tax on just the amount he removed - while completely deferring taxes on the rest of his exchange.

I completed exchanges for clients in each of the above situations during the last quarter of 2023. My investors were able to maximize their invested dollars and therefore maximize their income and growth potential, all while saving hundreds of thousands of dollars in taxes.

Are you having trouble finding a property that can help meet the leverage requirements of your exchange or would you like to take some "cash off the table?" Perhaps a 1031 "Combo Exchange" can help you too. If you have any questions, please call my office at (877) 313-1868.

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