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1031 Exchange

The Real Estate Investors Best Friend
By Leonard S. Spoto

The concept of tax free exchanges as set forth in Section 1031 of the Internal Revenue Code has been part of the tax code for over 80 years and has been used by countless investors as a means to defer capital gains taxes on the sale of investment real estate. Yet, today, many investors still fail to take advantage of what has been called the single greatest tool available to help create wealth. Unfortunately, many real estate investors are either unaware of its benefits or are confused with the guidelines that the IRS sets forth for conducting a 1031 Exchange.

What is Section 1031?

Section 1031 of the Internal Revenue Code establishes the rules for an investor to defer the payment of capital gains taxes on the sale of an investment property.

-Property Qualifications -The Internal Revenue Code states that the properties involved in an exchange must be held for productive use in trade or business or for investment, and they must be "like-kind". The "like-kind" requirement is often a source of confusion for investors. All real estate is like-kind, with the exception of real estate outside the United States. For example, provided the properties are within the U.S., an investor selling a rental home can exchange into a four-plex. Similarly, an investor selling a warehouse can exchange into a fractional interest in an office building.

-Timeline - The Internal Revenue Code provides 180 days for an investor to complete an exchange. The 180 day timeline begins at the close of the property being sold. Replacement property must be acquired on or before day 180. No Exceptions! If the investor cannot close on the replacement property on or before day 180, the exchange will fail. In addition, the investor must identify potential replacement property by

midnight of the 45th day. Many investors have difficulty finding suitable replacement property within the strict timeframe so advance planning is strongly recommended.

-Identification Rules - By day 45 of the exchange the IRS requires that the investor identify potential replacement properties that may be acquired. The IRS provides two rules for identifying potential replacement properties:

· The 3 Property Rule - Investors using the 3 Property Rule are allowed to identify three properties of any price. The identification must be done in writing and include an unambiguous description of the property.

Investors can change properties up until day 45, but there can be NO substitutions after day 45. If the investor cannot close on any of the identified properties, the exchange will fail. For this reason, it is very important to identify wisely.

· The 200% Rule - Investors wishing to purchase multiple replacement properties may choose to use the 200% rule for identifying. This rule allows the investor to identify as many replacement properties as they desire, provided the combined aggregate fair market value of all properties identified does not exceed 200% of the fair market value of the relinquished property. For example: Investor A sells a rental home for \$500,000. Investor A can identify ten \$100,000 rentals, five \$200,000 rentals or any combination of properties, provided the aggregate fair market value does not exceed \$1,000,000.

-100% Tax Deferral - If it is the intent of the investor to defer 100% of their capital gains taxes, the investor simply needs to a) reinvest all the cash that was generated from the sale of the relinquished property and b) purchase property equal or greater in value to the property sold. This can be accomplished in a variety of ways. For example, an investor selling a \$500,000 rental, with \$200,000 in equity, can purchase

two \$300,000 properties with a \$100,000 down payment on each. Investors wishing to exchange into a less valuable property (i.e. sell for \$500,000, purchase for \$400,000) can still utilize Section 1031 but they need to be aware that such a transaction will result in only a partial deferral of the tax liability. Some, but not all, of the taxes will be owed. To insure maximum benefit, it is suggested that the investor seek guidance from their tax professional prior to completing their exchange.

Why Exchange?

Tax Deferral

The primary motivating factor for any 1031 Exchange is the deferral of the capital gains taxes. An investor doing a 1031 Exchange can deferral payment of the following taxes:

- 15% Federal Capital Gains Tax
- 9.3% California Tax Rate (each state tax varies)
- 25% Federal tax rate for the recapture of depreciation

Buy More Real Estate - Utilizing Section 1031 of the Internal Revenue Code essentially provides for an interest free loan from the government. Instead of paying a tax liability now, savvy investors keep their money working for them. The sale of a duplex may result in a \$100,000 tax liability. Without Section 1031, that money goes straight to the government. With a 1031 Exchange, the investor defers payment of \$100,000 in taxes and has more money to leverage into additional real estate.

Diversification - In real estate, there are two ways to diversify, by geography and by asset class. If your portfolio is too heavily loaded in one particular geographic area or one particular property type, it may be time to

re-allocate some of your holdings. The best way to accomplish this is through 1031 Exchange.

Relief of Management Burden - Investors tired of dealing with tenants, leaky roofs and broken toilets may want to consider exchanging out of difficult to manage properties and into investments that require little or no management. It may also be wise to consolidate numerous difficult to manage properties into one or two easier to manage properties. Triple net lease properties and Tenant In Common Investments are just two vehicles available today that offer the investor relief of the management burden.

Conclusion

The United States government has provided a tremendous benefit to many investors in the form of Section 1031 of the Internal Revenue Code. Although this newsletter provides only a brief overview, it is definitely worthwhile for the real estate investor to have a solid understanding of the possibilities that exist within Section 1031. As a 1031 Exchange Qualified Intermediary, North American Exchange Company can provide additional insight into some of the more complex elements of exchanging, such as reverse exchanges, construction exchanges, when to refinance and how long to hold a property before exchanging

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