



The benefit of 1031 exchanges in today's market: The basics

By James Kilpatrick of Kilpatrick & Company

Everyone in the investment real estate market seems to be talking about 1031 exchanges. By most measures, roughly 50% of the sales occurring in today's investment real estate environment will involve a 1031 exchange. 1031 refers to the IRS code section 1031. This section describes what is allowable for selling property while deferring all capital gains.

Technically a "1031 exchange" is simply an exchange of one like-kind property for another. For our purposes you may assume "like-kind" to mean investment property. A single family home being used as a rental property, a 20 unit apartment building, or a net-leased drugstore all would qualify as investment properties.

While years ago the 1031 simultaneous exchange was more popular (the property you sell and the property you buy change hands on the same day) now almost everyone performs a delayed exchange which means roughly that you sell a property, the proceeds from the sale go to an independent "exchange accommodator", you pick a property to buy within 45 days, and then by the 180th day after you sell, you close (the deed transfer is recorded) on the upleg (or replacement property).

The reason to go through all of that hassle is that no capital gains are realized as long as the 1031 exchange rules are followed. Aside from the general mandatory guidelines of using an exchange accommodator, picking your replacement property within 45 days, and closing on your upleg (replacement) property within 180 days, it is essential that the replacement property be of equal or great value, and also that all proceeds from the sold property go directly towards the down payment of the replacement property.

While the narrow timeline for finding a replacement property can be challenging for some, it can also be an asset. When you go to purchase a property a Seller will know you're serious if you are in a 1031 exchange. It is very likely he or she will pick you over another potential non-exchange buyer even if your price is a little lower or just the same.

Much like a 401(k) or other tax deferral retirement plan, with your new building you will be earning cash flow on a larger sized property and essentially earning returns off of money that would have gone to the government. If you trade up (into a larger property with more debt or by adding cash) you will have a larger basis for tax purposes meaning

more write-off. You will control more real estate meaning that if the market goes up you will benefit more than you would have with the smaller property, but you also would experience more “paper loss” if real estate values went down. Generally larger properties have fewer competing buyers and therefore must offer a superior return.

This is just an introduction to some of the benefits of a 1031 exchange. Techniques are constantly changing and evolving and of course tax regulations are known to change so be sure to consult the appropriate expert to make sure you understand all the potential risks and rewards prior to committing to anything.

Please keep in mind that my area of expertise is Real Estate Brokerage. The tax consequences, exchange validity, accounting rules and legality of various strategies are best discussed with the appropriate professional. I have several that I will be happy to recommend. If you missed last month's installment, you may contact me for a copy of the last issue.

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