AN INVESTMENT MANAGEMENT COMPANY

1031 Exchange Explained

1031 Exchange. You may have heard this phrase before, you may already be familiar with what it is, or you may not know what it is at all. Whichever category you fall under, you are most likely interested in a tax-efficient way of preserving capital invested in real estate.

Section 1031 of the Internal Revenue Code provides an exception that allows you to defer payment of capital gains taxes when you sell business or investment property if you reinvest the proceeds in similar property through a like-kind exchange. A like-kind exchange means you can exchange property used in your trade or business or held for investment for property to be used in your trade or business or held for investment. Thus, the phrase *1031 exchange* was coined from the parameters of this tax code. This may seem simple enough, but there are many steps to take and requirements to meet when actually going through the 1031 exchange process. To illustrate a tax-deferred 1031 exchange, let's explore a fictional case about Mr. Capital.

Mr. Capital is the owner of a 30-unit apartment investment property in California that has appreciated almost three-fold since he originally purchased it 20 years ago. Given this increase in value and Mr. Capital's desire to invest in a property in Texas with his profits, he decides to sell the property. Before he enlists his real estate broker to market the property, he calls up his long-time CPA to evaluate his tax considerations related to selling his apartment property. Over Mr. Capital's 20 years of ownership, his net adjusted basis (calculated as: original purchase price + capital improvements - depreciation taken) has decreased quite significantly due to the depreciation he has recognized.

Original Purchase Price	$1,500,000
Capital Improvements	$50,000
Depreciation Taken During Holding Period	($1,000,000)
Net Adjusted Basis	$550,000

During that conversation, Mr. Capital's CPA informs him that his capital gain (calculated as: the sales price if the property were sold today – net adjusted basis – closing costs) and resulting tax liability are significant given the strong asset appreciation and his low net adjusted basis. Here is a breakdown of his potential sale:

Sales Price if Sold Today	$4,250,000
Net Adjusted Basis (from above)	($550,000)
Closing Costs Related to the Sale	($200,000)
Capital Gain	$3,500,000

Mr. Capital's CPA goes on to explain that his $3.5 million capital gain figure is comprised of $1 million in depreciation recapture, which is generally taxed at a rate of 25%. Since Mr. Capital is in the highest tax bracket, the remaining $2.5 million in capital gain will be taxed at a long-term federal capital gain rate of 23.8% (20% long-term capital gain rate + 3.8% Medicare surtax on Net Investment Income). Since Mr. Capital is a California resident, he is also responsible for paying California state tax at a 13.3% rate. His potential tax liability looks like this:

Capital Gain	$3,500,000
Depreciation Recapture	($1,000,000)
Net Capital Gain	$2,500,000
Tax on Depreciation Recapture (25%)	$250,000
Federal Capital Gains Tax (20% Federal Rate)	$500,000
Medicare Surtax (3.8%)	$95,000
State Tax (13.3% California Rate)	$332,500
Total Tax Liability	$1,177,500

Given the remaining loan balance on the property of $800,000, the net cash proceeds after paying off the loan and paying closing costs at sale would be $3,250,000 ($4,250,000 - $200,000 - $800,000). If Mr. Capital takes the cash, he will end up with approximately 64% of his sale proceeds after paying taxes (($3,250,000 - $1,177,500) / $3,250,000). At this point, Mr. Capital's CPA suggests he utilize a 1031 tax-deferred exchange to defer his capital gain taxes and preserve his wealth. Here is a comparison of what purchasing power Mr. Capital would have if he were to pay the capital gains taxes and reinvest his proceeds on an after-tax basis (assuming he leverages his new acquisition at a 70% loan-to-value ratio) vs. reinvesting on a tax-deferred basis:

After-tax Sale Proceeds ($3,250,000 - $1,177,500)	$2,072,500
Maximum Purchase Price of New Property (with 70% leverage)	$6,908,333
1031 Exchange Tax-Deferred Sale Proceeds	$3,250,000
Maximum Purchase Price of New Property (with 70% leverage)	$10,833,333
Purchasing Power Advantage with 1031 Exchange	**$3,925,000**

After seeing this comparison, Mr. Capital is inclined to exchange his sale proceeds using a 1031 exchange. Next, he contacts his real estate broker to market the property for sale. Within 30 days, Mr. Capital receives multiple offers and decides to move forward with the most qualified buyer. 45 days later, the property is sold to the buyer for $4,250,000. The sale proceeds are transferred directly to an exchange accommodator (a.k.a. Qualified Intermediary) to hold the funds until a replacement property is purchased. This Qualified Intermediary is a very important part of the exchange process because if Mr. Capital were to access his sales proceeds directly, he would be deemed to violate the requirements of Section 1031 and would trigger a taxable event. The following outlines the necessary steps in a 1031 exchange and the corresponding requirements:

Replacement Property Identification

The first step after selling an investment or business-related property and transferring the cash proceeds to an exchange accommodator is to mark your calendar for two key dates: the end of the replacement property identification period and the deadline for completing the purchase of a replacement property or properties. Starting on the closing date of your relinquished property, you have 45 days to identify potential replacement properties to be purchased with your sales proceeds. From the same close date of your relinquished property, you have 180 days to complete the acquisition of your replacement property or properties. For example, if you sold a property on January 15, 2014 then the second day of your identification period will be January 16, 2014.

	Identification Deadline	Purchase Deadline
Days from the date of sale	45 days	180 days

Three-Property Rule: You may identify up to three different properties as potential purchases within the 45-day identification period regardless of the total fair market value of the properties.

200% Rule: Alternatively, you can identify an unlimited number of replacement properties as long as the total fair market value of all properties does not exceed 200% of the value of all relinquished property in the same exchange.

95% Rule: Another alternative is you may identify alternative properties as long as you receive at least 95% percent of the value of all identified replacement properties before the end of the exchange period.

You must meet the criteria of at least one of these rules for the identification of alternative replacement properties to be valid.

Replacement Property and Debt Requirements

When choosing replacement properties, you must keep a few rules in mind to ensure a proper exchange is completed.

The replacement property must be of equal or greater value, net of closing costs, than the relinquished property and all exchange equity must be reinvested for full tax-deferral. When purchasing multiple properties, the aggregate value of real estate must be equal or greater. Simply put, the two rules are "trade up" and "get no cash out."

The debt on the new property or properties should also be equal or greater than the debt on the relinquished property, but fresh cash can be added to the transaction to offset a shortfall in replacement debt.

Boot

Under the rules of IRS code section 1031, only like-kind property held for investment or business purposes qualifies for a 1031 exchange. In some instances there are items in an exchange that do not qualify for tax-deferral. Such items received are known as boot and can trigger a taxable event on the portion of the exchange that is not considered like-kind property.

Cash Boot: This occurs when the exchanger receives cash as part of the exchange. The exchanger doesn't necessarily have to receive the cash proceeds in order for it to be taxable. For example, when a replacement property requires capital expenditure dollars to fund certain upgrades at the property that are made outside of the exchange, the capital expenditure dollars do not represent like-kind property and, therefore, could be cash boot.

The following is a list of example allowable and non-allowable expenses and closing costs in a 1031 exchange:

Allowable Expenses and Closing Costs:

-Real Estate Broker's Commissions

-Qualified Intermediary fees

-Recording or Filing Fees

-Attorney Fees Related to the Acquisition

-Tax Advisor Fees Related to the Acquisition

-Owner's Title Insurance Premiums

-Escrow or Settlement Agent Fees

-Finder Fees or Referral Fees-Documentary Transfer Taxes

Non-Allowable Expenses and Closing Costs:

-Financing Fees (loan fees, loan points, appraisal fees, mortgage insurance premiums, lender's title insurance policy premiums, and other loan processing fees)

-Property Taxes

-Prorated Rents

-Repairs and/or Maintenance Costs

-Insurance Premium Payments

Mortgage Boot: When an exchanger reduces the mortgage liabilities on a replacement property below the relinquished property's mortgage liabilities, mortgage boot is present. Therefore, the replacement property's debt must be equal or greater than the sold property's debt.

In both cases of cash boot or mortgage boot, additional fresh cash can be added to offset these effects.

Conclusion

Now that we have gone through the steps and rules pertaining to a 1031 exchange let's return to the example of Mr. Capital. Let's assume Mr. Capital finds a replacement property that suits his needs and reinvests his sale proceeds of $3,250,000 (from earlier) on a tax-deferred basis and will earn 6% per year in cash flow from property operations equating to $195,000. If instead he reinvests his sale proceeds on an after-tax basis of $2,072,500 (also from earlier) the replacement property will have to produce a 9.4% annual cash flow yield to match the $195,000 from the 1031 exchange scenario.

1031 Exchange Investment Base	$3,250,000
Replacement Property Annual Yield Assumption	**6%**
Annual Cash Flow	$195,000
VS.	
After-Tax Investment Base	$2,072,500
Target Annual Cash Flow to Match 1031 Exchange	$195,000
Required Annual Yield to Match 1031 Exchange	**9.4%**

In addition, with the larger purchasing power gained through a 1031 exchange, Mr. Capital should be able to recognize greater depreciation on his replacement property than he would on a lower-valued property. Greater depreciation translates into more tax shelter for cash flow.

There are many considerations when engaging in a 1031 exchange, but if managed correctly you can take advantage of the tax-deferral benefits the IRS code has to offer. Consult your tax advisor for your specific case.

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