



The Power of Exchange

The 1031 tax deferred exchange is one of the most powerful wealth creating tools available to United States taxpayers. The 1031 exchange is the only method under which U.S. taxpayers can defer payment of taxes on gain and recapture in order to reinvest 100% of their pre-tax proceeds into a new investment. The 1031 exchange is available primarily to real estate investors.

As an illustration of the wealth creating power of a 1031 tax deferred exchange, let's look at the following example:

Taxpayer owns Property A, which they acquired 12 years ago for \$6,000,000 (consisting of \$2,000,000 cash and \$4,000,000 debt with 25-year amortization). The ratio of land to improvements was 25/75 and the Taxpayer is in the 15% capital gains tax bracket. Now, Taxpayer sells Property A for \$10,000,000. Her depreciated basis in the property is approximately \$4,633,000 and her loan balance is approximately \$2,890,000. Her cash from the deal (before costs) is approximately \$7,110,000. However, her gain is approximately \$5,367,000 on which, she will pay approximately \$942,000 in taxes (\$600,000 on the appreciation at a capital gains tax rate of 15% and \$342,000 in depreciation recapture at a tax rate of 25%), leaving cash of approximately \$6,168,000. Using the same leverage ratio as in her original investment, the Taxpayer will now be able to acquire assets valued at approximately \$18,690,000. Not bad at all. Unless you compare it with a tax deferred exchange.

Take the same example, but defer the taxes. Now, the Taxpayer has \$7,110,000 of cash to reinvest. Again, using the original leverage ratio, the Taxpayer will be able to acquire Property B valued at \$21,500,000. Cost of the exchange; less than \$1,000. Increase in wealth; \$2,800,000. Value of not writing a check to the IRS for over \$940,000; priceless.

As if that was not reason enough to use a tax deferred exchange, let's look at another example. Say you are closing on the sale of a property in December. If you do not use a tax deferred exchange, you have a taxable event in that year. However, if you use a tax deferred exchange, the 45-day identification period does not expire until the following calendar year. Even if you are ultimately unable to find appropriate replacement property, you have deferred the payment of taxes for up to one year. Using the example from above and assuming a cost of funds of 5.0%, the tax deferral is worth about \$47,000. Not bad for an investment of less than \$1,000.

Last year, approximately \$350 billion of investment real estate (non-primary residences) transactions took place in the United States. Approximately \$125 billion to \$150 billion of this involves institutional (or quasi-institutional) transactions by tax-exempt entities (therefore, not subject to the use of a 1031 exchange), leaving approximately \$200 billion to \$225 billion of transactions that may potentially benefit from the use of a 1031 exchange (including transactions by REITs). About \$150 billion of these transactions utilized a 1031 exchange.

While the 1031 tax deferred exchange is a very powerful tool, only a fraction of the property transactions that may qualify actually utilize a 1031 exchange. We have found that this is most often caused by a lack of knowledge of a 1031 exchange, misinformation or a misunderstanding of the rules governing a 1031 exchange, or fear that the investor will not be able to locate and acquire appropriate replacement property within the strict statutory time limits. Fortunately, in most cases these issues are easily resolved.

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Many investors are unclear as to which properties are able to utilize a 1031 tax deferred exchange. Any property held for investment or for use in a trade or business by a U.S. taxpayer is potentially suitable for a 1031 exchange. This can include land, second homes, co-ops, condos, mobile home parks, or any type of property (income producing or not) that is held for investment or for use in a business or trade.

Investors are frequently confused by the use of the term 'like-kind' in the 1031 exchange rules. They are concerned that the property that they are selling will not be considered 'like-kind' with their intended replacement property. For example, maybe the investor is selling a ranch and wants to replace it with a triple-net single-tenant property. Or, perhaps they sold several single-family homes and wish to acquire an office building. Or, maybe it is the other way around. In fact, the regulations governing 1031 exchanges make it clear that any property, located in the United States and held for investment or in use in a trade or business, may qualify for use in a 1031 tax deferred exchange. Land may be exchanged for improved property; single-family homes may be exchanged for commercial properties, etc.

Many investors are confused as to how many potential replacement properties they can identify. The simple answer is the three-property rule, which states that up to three potential replacement properties, of any value, can be identified for each exchange. Since most exchanges involve one relinquished (sold) property, the general rule is that you can identify three potential replacement properties for each property relinquished. There are additional (more complex) rules that allow the identification of more than three properties, but most investors use the three-property rule because of its simplicity. Regardless of the rule used to identify replacement property, there is no requirement that a property be under contract or in escrow to be identified.

As to the last concern, the inability to locate and acquire appropriate replacement property within the strict statutory time limits, investors clearly have a point. While current regulations allow both simultaneous exchanges (where the relinquished property and the replacement property close at the same time) and delayed exchanges (where the replacement property is acquired after the sale of the relinquished property), most investors use a delayed exchange to allow time to locate and acquire their replacement property. The existing rules regulating use of 1031 exchanges provide for identification of any potential replacement property(s) within 45-days of the sale of the relinquished property(s) and final purchase of all of the properties used to complete the exchange within 180 days of the sale of the relinquished property(s). These time limits pose a significant burden and cannot be extended.

Of the approximately \$150 billion of 1031 exchanges initiated last year, approximately \$10 billion to \$15 billion fail, primarily because of the inability to locate and acquire appropriate replacement property. Fortunately, companies such as CapHarbor have developed various solutions to this problem and are providing the products and services to greatly reduce the failure rate of 1031 exchanges.

The final (and perhaps most important) issue in a 1031 exchange is the selection of a qualified intermediary. Under current regulations, a qualified intermediary must be used in order for a 1031 exchange to be valid. The qualified intermediary will hold the proceeds from the sale of the relinquished property. They will handle all of the mechanics of the exchange. They will make sure that the exchange is handled and executed in a proper manner. Frankly, we find that far too often an investor will not pay enough attention to the selection of a qualified intermediary and will make the selection primarily (or exclusively) on price. Let me repeat, the qualified intermediary holds the money and handles the mechanics of the exchange. If they fail at either job, the exchange fails.

Qualified intermediaries are un-regulated. They are not insured by the government, or by any other industry-wide insurance pool. We have seen numerous instances where the proceeds from the relinquished property were unavailable (lost, embezzled, or frozen) to fund the acquisition of the replacement property. In that case, of course, the exchange fails and the investor must find some way to pay their taxes. We have also seen instances where qualified intermediaries play games to (fraudulently) extend either the identification or acquisition time limits for their clients. There is a simple two-word reason why you do not want to do business with a qualified intermediary who will play such games: tax fraud, to which you

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may be an accessory. In addition, any qualified intermediary who is found to have engaged in such actions faces the possibility that every exchange that they have ever handled may also be disallowed.

Fortunately, most qualified intermediaries are honest, hard working and financially prudent. Even more fortunate is that each of the qualified intermediaries who participate in CapHarbor is of superior financial strength, with the highest degree of professionalism and service.

Finally, use of a 1031 exchange provides for additional transactions, with associated commissions, fees and other revenue for various service providers, without the cost of originating additional clients. This alone should cause brokers, agents, attorneys, accountants and financial planners to learn more about the power of a 1031 exchange for their clients, thus helping to overcome the first obstacle listed above, lack of knowledge of the power of a 1031 exchange.

CapHarbor is a real estate brokerage company serving the needs of 1031 investors who are seeking passively managed replacement properties (Single-Tenant, NNN-Leased properties by the whole through our real estate licenses and tenant in Common (TIC) interests on a fractional basis for accredited investors through our securities licenses). Visit us at www.capharbor.com or call 877-886-1031 to learn more about our services.

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