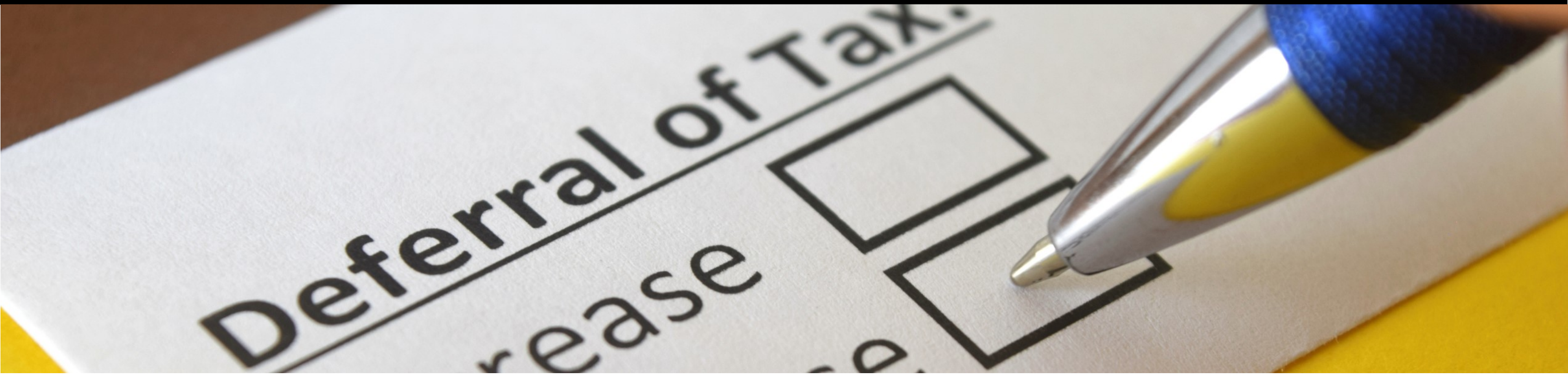
10 Reasons to Exchange and Never Pay Capital Gain Taxes Again

ASSET PRESERVATION®
INCORPORATED

10 Reasons to Exchange and Never Pay Capital Gain Taxes Again



The familiar adage, *"It's not how much you make, but how much you keep,"* rings truer than ever for investors who own investment real estate in today's tax environment. Fortunately, IRC Section 1031, a provision in the tax code since 1921, provides critically needed tax deferral. 1031 exchanges are a popular tax-deferral strategy for investors and business owners who want to accomplish a wide range of investment objectives, including some of the following

1. TAX DEFERRAL

Absent the tax deferral benefits of a 1031 exchange, a real estate investor can face four potential taxes. By performing a 1031 exchange, an investor can defer paying all of the taxes noted below:

A. Depreciation Recapture: An investor is taxed at a rate of 25% on all depreciation recapture.

B. Federal Capital Gain Taxes: Next, an investor will owe federal capital gain taxes on the remaining economic gain depending on their taxable income. High earners face a 20% federal capital gain tax rate, and a 15% capital gain tax rate applies to taxpayers below these threshold income amounts.

C. Net Investment Income Tax Pursuant to IRC Section 1411: When applicable, an additional 3.8% surtax applies to an investor with "net investment income" who exceeds the threshold income amounts of $200,000 for single filers and $250,000 for married couples filing jointly. Under IRC §1411, "net investment income" includes interest, dividends, capital gains, retirement income, and income from partnerships (as well as other forms of "unearned income").

D. State Taxes: Last, investors must also take into account the applicable state tax, if any, to determine their total taxes owed. The highest state tax presently is 14.4% in California.

All four of the above tax computations should be considered before closing on the sale of an investment property. It is not uncommon for many investors to discover that 30-40% or more of their profit may be used to pay the four different taxes owed in a taxable sale.

2. PRESERVATION OF EQUITY / INCREASED ROI

The benefit of tax deferral in a 1031 exchange is having the entire gross (pre-tax) equity available from the sale of a relinquished investment property to reinvest in a like-kind replacement property. This essentially equates to an interest-free, no-term loan on taxes due until the property is sold for cash. In many cases, an investor may opt to continually exchange properties and never sell and pay capital gain taxes. In this scenario, the investor who exchanges defers paying capital gain taxes for their entire lifetime, and their heirs receive a full step-up in basis when the property is inherited. However, an investor who sold in a taxable sale would only have the net (after-tax) equity available to redeploy into an investment property purchase. Ultimately, an investor who performs 1031 exchanges is able to acquire considerably more investment real estate than an investor who sells and pays all taxes owed at every disposition. Tax deferral significantly improves an investor's return on investment.

3. LEVERAGE

Some investors exchange a property where they have a high-equity position or one that is "free and clear" with no mortgage into a larger and more valuable property or properties, using the funds from a lender to increase leverage. The obvious benefit is that the investor can use their equity for the down payment and the lender's funds for up to 80% of the purchase price of a considerably larger property than could be purchased using all cash. Taking advantage of leverage and financing provided by a lender to acquire more investment property via a 1031 exchange provides a better return on investment and a higher cash-on-cash return. A larger property will provide a significantly better return on investment, with more cash flow, increased appreciation, and additional depreciation benefits.

4. ASSET DIVERSIFICATION

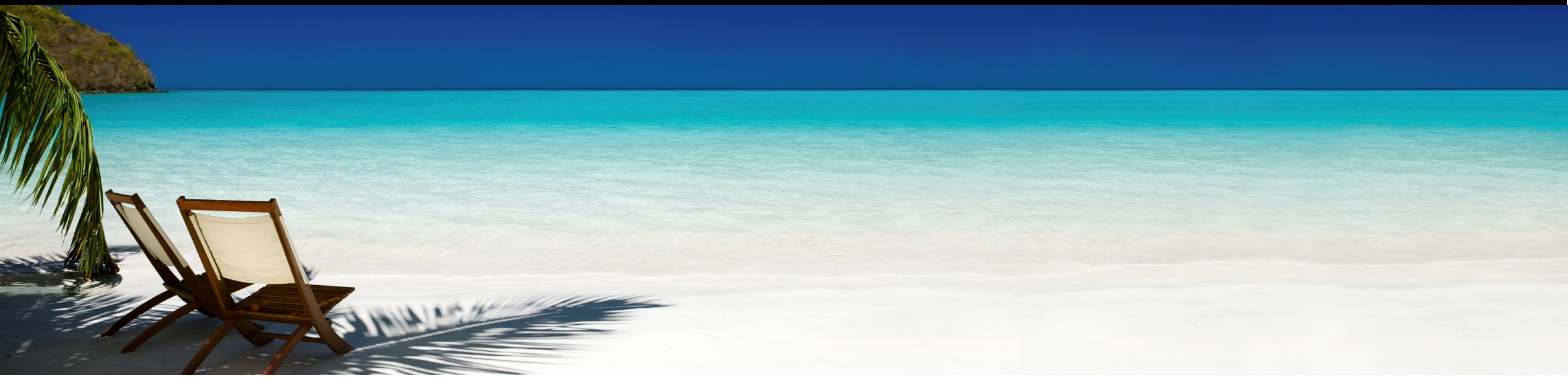
1031 exchanges allow a real estate investor to have many opportunities for diversification. One option is to diversify out of one real estate asset class and into another. For example, a 1031 investor can exchange out of bare land that produces no income into a fourplex that provides both cash flow and depreciation benefits. Alternatively, a 1031 exchange investor could exchange out of a multi-family property into a commercial office, industrial, or retail property as a replacement. The ability to transition between different asset classes is beneficial over a longer time horizon. Many investors may opt to exchange into more passive investments like tenant-in-common (TIC), Delaware Statutory Trusts (DST), or NNN property as their investment strategy evolves, and the need for maximizing appreciation transitions into a preference for passive cash flow and reduced management responsibilities.

5. GEOGRAPHIC DIVERSIFICATION

Many investors can benefit from moving out of having all their real estate assets in one marketplace and diversifying into several different states or multiple markets within a state. This diversification provides added benefits because, over time, some markets may end up being better at attracting jobs and population growth, variables that increase demand, rents, and long-term price appreciation. An investor may choose to exchange out of a state where property has appreciated considerably in the past, like California, and exchange into multiple smaller investment properties in states that are attracting population growth, like Florida, Tennessee, or Texas. Many of the states with no state income tax are seeing a large influx of new businesses and residents, which is a favorable trend for real estate investors.

6. CREATIVE LIKE-KIND PROPERTY ALTERNATIVES

Some investors may not be aware that a wide range of property rights can qualify for Section 1031 tax deferral. Investors can exchange out of or into these creative property types and obtain the benefit of tax



deferral. These creative alternatives include conservation easements, perpetual communication easements, agricultural easements, water rights (in certain states), air rights (commonly referred to as transferable development rights), and certain oil, gas, and mineral rights. Fractional ownership programs, such as the popular tenant-in-common (TIC) and Delaware Statutory Trust (DST) arrangements, offer investors the opportunity to acquire a slice of a much larger commercial replacement property. These programs qualify for 1031 exchange tax deferral and are available only to accredited investors through financial advisors with the necessary securities qualifications. The definition of qualifying real property is very broad, and generally, state laws dictate what is considered qualifying real property.

7. LANDLORD-FRIENDLY STATES

Investors use 1031 exchanges to transfer investment capital out of states with laws favoring tenants over landlords. Real estate investors use exchanges to reinvest in communities and states where local and state laws provide a favorable environment for property owners and are more landlord-friendly. Redeploying investment capital into areas with more balanced laws and regulations helps investors avoid long periods without rental income and obtain a better return on investment over time.

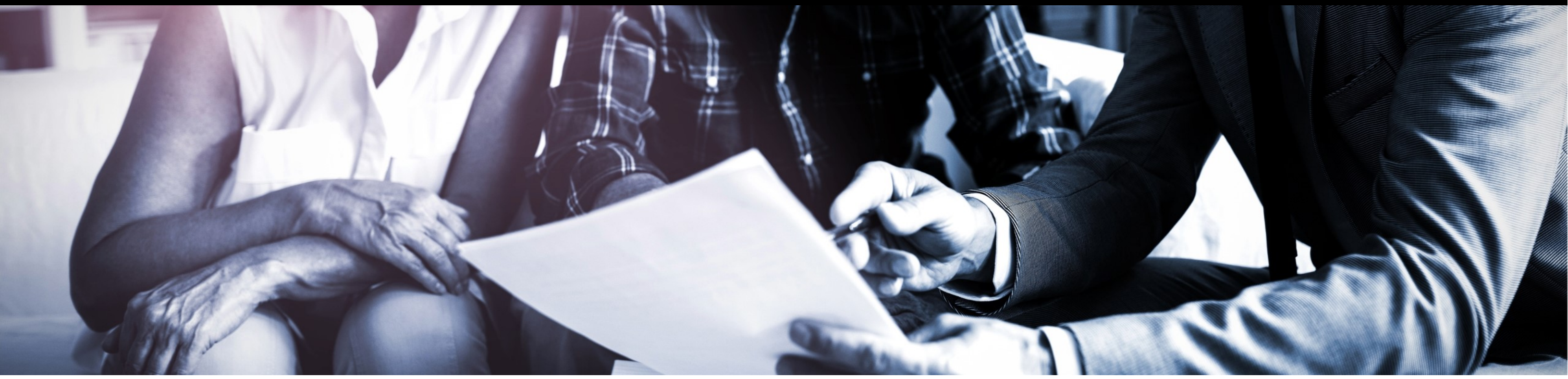
8. LIFESTYLE RENTAL PROPERTY IN VACATION DESTINATIONS

Although a second home with no rental income will not qualify for a 1031 exchange, a vacation property held for investment that meets the requirements of Revenue Procedure 2008-16 does qualify for 1031 tax deferral.

Revenue Procedure 2008-16 created a safe harbor definition of investment property. In short, the IRS will not challenge whether a residential property or vacation home property is held for productive use in a trade or business or for investment if certain specified ownership and use requirements are met.

The IRS will not challenge whether a dwelling unit qualifies as 1031 exchange property if:

1. the relinquished property is owned by an investor for at least 24 months immediately prior to the 1031 exchange, and a replacement property is owned for at least 24 months immediately after the exchange (the “qualifying use period”); and
2. within each of the two 12-month periods constituting the qualifying use period, the investor must rent the property at fair market rent for 14 or more days; and
3. The investor’s personal use of the property cannot exceed the greater of 14 days or 10 percent of the number of days the property is rented at a fair market rent.



9. MANAGEMENT RELIEF

Many investors have acquired multiple single-family rental properties over the years. The ongoing maintenance and management of what can be a far-reaching group of single-family properties can be lessened by exchanging these properties in different locations for one replacement property better suited to on-site maintenance and management. Performing a 1031 exchange into a single multi-family property with a resident manager is an example of this strategy. Another approach to reducing management responsibilities is to exchange into an NNN property, where the tenant is responsible for most of the ongoing management and maintenance.

10. ESTATE PLANNING

It is not uncommon for family members to inherit one large property and disagree about what they want to do with the property. Some family members may want to continue holding the property, while others may want to sell it to obtain cash. This disagreement can lead to squabbles among family members in the future. Another approach to avoid these types of issues is for the investor to exchange out of one sizable, relinquished property into several smaller replacement properties while the taxpayer is alive to reposition their real estate assets. In this manner, an investor can proactively plan in advance and designate that, after their death, each of their heirs receives a different property which they can own individually and either hold for long-term investment or sell if obtaining the cash proceeds is a better fit for their individual financial situation. 1031 exchanges are a great tool for advance planning and redeploying investment capital into a situation that meets an investor's long-range planning objectives.

In conclusion, 1031 exchanges offer a robust mechanism for real estate investors to defer taxes, enhance equity, and strategically manage their portfolios. By understanding and leveraging these benefits, investors can significantly improve their investment outcomes and achieve their long-term financial objectives.

Click a link below to access more 1031 exchange resources

Capital Gain Tax Calculation
Open New 1031 Exchange Online
Sign up to Receive 1031 Exchange Updates
45/180 Day Calendar
Useful Tax Links

ASSET PRESERVATION
INCORPORATED

A National IRC §1031 "Qualified Intermediary"

NATIONAL HEADQUARTERS
800.282.1031 | 916.791.5991

EASTERN REGIONAL OFFICE
866.394.1031 | 631.369.3617

apiexchange.com | info@apiexchange.com