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How can a 1031 exchange help me?



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Do you have an investment property you want to sell, but feel there are not enough options for diversification? If you answered yes to the above question, or if you are feeling slightly curious, this article is for you.

Often overlooked, a 1031 exchange is considered one of the best-kept secrets in the Internal Revenue Code. If you qualify, a 1031 exchange can offer significant tax advantages. Under Section 1031 of the Internal Revenue Code, if you own real property you can sell your property and reinvest the sale proceeds in a “like-kind” property and defer the capital gains taxes.

In order for a property to qualify as a “like-kind” exchange, property exchanges must follow the rules set forth in the tax code and treasury regulations. Some examples of a “like-kind” property exchange are apartment buildings for farm/ranch property; office building for a hotel; raw land for retail space; unimproved property for commercial property.

There are five tax classes of property: property used in taxpayers trade, or business, such as airplanes; property held primarily for sale to customers; your principal residence; investment property, and vacation homes. A 1031 Exchange may be applied to all of the above situations except for your principal residence.

In addition to deferring capital gains taxes, a 1031 Exchange also allows for diversification.

You may own more than one interest in multiple properties such as an apartment complex, a storage unit facility, office building, or a senior living facility to name a few.

You may also invest in different geographic locations. There are properties to purchase in every state and in different countries. However, when investing in a property outside of the United States you will want to seek tax advice to make sure the property qualifies for the same tax advantages as a domestic property.

As with any good idea, there are always important rules involved. First, a 1031 Exchange property must be for a productive use or investment. As mentioned above, it may not be used for your principal place of residence. Your sale proceeds must go through a qualified intermediary in order to be considered not taxable. Your cash proceeds must be reinvested within 180 days of the closing date of your relinquished property. Otherwise, you may be subject to taxation.

Another rule is known as the 200 Percent Rule. This would have an effect on an investor who wishes to diversify and would like to invest in more than one property. You may identify any number of

properties as long as the aggregate value of these properties does not exceed 200 percent of the value of your relinquished property.

There is a timeline regarding a 1031 Exchange known as the Identification Period and the Exchange Period.

The Identification Period is the first 45 days following the sale of your existing property. During the Identification Period you must abide by the Three Property Rule, which means you must identify at least three properties you are considering as possible replacements for your relinquished property.

Further, you need to make sure you are exchanging an equivalent amount of equity and debt otherwise you will have to pay taxes on the remaining difference, which is better known as “boot.”

A common question I hear is why an investor has to select at least three properties. The answer is it is for the investor’s protection. The two other properties will provide an alternative in the event a selected property does not close on time or if one of your investment ideas falls through.

A 1031 Exchange is only one example of the many investment vehicles available that can help people. Please keep in mind, since your personal situation is unique, I highly recommend you seek advice from both a financial professional and tax consultant before investing in a 1031 Exchange.

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