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Its time for change: A story of appreciation, depreciation, cash flow, diversification & tax deferral

September 13, 2012 - Financial Digest

If an investor bought an apartment building for $100,000 in 1975 and it is now valued at $1.8 million, the property has appreciated significantly and is now worth eighteen times what it was in 1975. Clearly, this was a great investment. But, like all investments, one should analyze whether it is now better to hold or to divest the asset.

The apartment building is currently owned free and clear of debt. It has been owned for more than 27.5 years so it is fully depreciated and no longer eligible for annual depreciation deductions on the investor's tax return. Reviewing the cash-flow, after property taxes, maintenance, and insurance, it produces net rental income of about $3,000 per month.

$36,000 per year on an investment property worth $1.8 million amounts to 2% annual income on the investment. However, the original $100,000 investment has grown by 1800% and there is now $1.8 million worth of equity tied up in one asset. Since interest rates are at historic lows, what better time than now, when property values are lower than they were a few years ago, to unlock some of that equity and exchange, tax deferred, into one or more properties with greater income and long-term appreciation potential?

Through an I.R.C. Â§1031 exchange, this real estate investor can sell his investment property and accomplish a number of tax and investment goals. A 1031 tax deferred exchange permits the investor to defer federal and state capital gains and depreciation recapture taxes. The investor can buy property with improved cash-flow, and if encumbered, with an interest deduction to be claimed. If the replacement property is greater in value than the relinquished apartment building, then depreciation deductions will also be available for the increased basis (the difference between the purchase cost of the new property, less the gain deferred on the exchange of the old property). Additionally, because multiple properties can be acquired through a single exchange, the investor can diversify the real estate portfolio, thereby hedging the investment risk inherent in a single property.

Appreciation, depreciation, cash-flow, diversification and tax deferral are important drivers for doing a Â§1031 exchange. Investors should examine their real estate holdings and do the 5 point analysis suggested in this article. If repositioning a real estate portfolio is in order, the valuable tax benefits of a 1031 exchange should be considered. Investors will need a strong Qualified Intermediary with a proven track record of success that can partner with advisors to maximize their clients' qualifying investments through a Â§1031 exchange strategy.

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