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Three reasons real estate investors should consider 1031 Exchange

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There's no doubt that owning commercial real estate in Boston right now is a great investment as prices continue to rise and vacancies continue to fall. However, investors and owners who decide to sell an investment property sometimes find themselves in a bind due to steep capital gains tax on any profit made from the sale, up to 23.8 %.

Owners in this position, that want to defer any tax liability and continue investing in real estate, should consider a 1031 Exchange for the greatest value. We have seen an increased number of these exchanges at NAI Hunneman in the last couple of years and thought it would be a good idea to explain what it is and the advantages of doing a 1031 Exchange.

How it works: In a 1031 Exchange, the owner of an investment property has the option of selling that property and using the cash to reinvest the equity in a "like-kind" replacement property (or properties) of equal or higher value. This also includes taking on equal or greater debt on the replacement property. Once initiated, the cash from the sale must be held by a Qualified Intermediary, that will purchase the replacement property on behalf of the owner. The intermediary most often will assist in the search for potential replacement properties for the owner.

The other important aspect of a 1031 Exchange is the time period in which both transactions (selling the original property and purchasing the replacement) must take place. The whole process from start to finish is to last no longer than 180 days. The IRS does NOT allow extensions for 1031 Exchanges. This includes a 45 day window after the start of the "exchange period" (the whole 180 day process) where the owner must identify replacement property options. This is often called the "identification period." Identified exchange properties must follow one of the following rules:

* The three property rule. The exchange can be for up to any three properties regardless of their market value

* The 200% rule. Any number of properties as long as their total Fair Market Value (FVM) of the replacement properties does not exceed 200% of the total sale price.

* The 95% rule. Any number of properties as long as 95% of the FMV of the total properties identified is acquired.

While having to follow such rules can seem difficult, there are three clear reasons for a 1031 Exchange could be a smart move:

1. Deferring capital gains taxes. This is the most advantageous aspect about a 1031 Exchange. But the owner may also eliminate paying the high-rate taxes on the recapture of depreciation taken on property as well.

2. Exchanging for a property that alleviates owner stress. The owner has the opportunity to exchange a management intensive property for a triple-net property, or for multiple properties that can be professionally managed.

3. Increasing cash flow. A replacement property that generates a higher operating income or can be refinanced more easily than the exchanged property increases the money flowing back to the owner.

A 1031 Exchange is a great option for property owners looking to cash in on their investment at the peak of the market, but want to avoid capital gains taxes and continue to generate income. Just make sure that you have all of the necessary information about the finer details of the process to ensure a smooth, pain-free exchange.

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