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Section 1031 exchanges can be the real estate investor's best friend when utilized correctly

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The concept of tax free exchanges as set forth in Section 1031 of the Internal Revenue Code has been part of the tax code for over 85 years and has been used by countless investors as a means to defer capital gains taxes on the sale of investment real estate.

What is Section 1031?

Section 1031 of the Internal Revenue Code establishes the rules for an investor to defer the payment of capital gains taxes on the sale of an investment property.

Qualifying Property: The Internal Revenue Code states that the properties involved in an exchange must be held for productive use in trade or business or for investment, and they must be "like-kind." All real estate is like-kind, with the exception of real estate outside the U.S.

Timeline: The Internal Revenue Code provides 180 days for an investor to complete an exchange. The 180 day timeline begins at the close of the property being sold.

Replacement property must be acquired on or before day 180.

Identification Rules: By day 45 of the exchange, the IRS requires that the investor identify potential replacement properties that may be acquired. The IRS provides three rules for identifying potential replacement properties:

* The 3 Property Rule: Investors using the 3 Property Rule are allowed to identify three properties of any price. The identification must be done in writing and include an unambiguous description of the property. Investors can change properties up until day 45, but there can be no substitutions after day 45. This is the most popular option.

* The 200% Rule: Investors wishing to purchase multiple replacement properties may choose to use the 200% rule for identifying. This rule allows the investor to identify as many replacement properties as they desire, provided the combined aggregate fair market value of all properties identified does not exceed 200% of the fair market value of the relinquished property.

* The 95% Rule: A final option for the investor is the 95% rule. An investor may identify an unlimited number of properties of any value, but then must actually acquire replacement properties equal to 95% of the aggregate value of all properties identified.

100% Tax Deferral: If it is the intent of the investor to defer 100% of their capital gains taxes, the investor simply needs to:

a) Reinvest all the cash that was generated from the sale of the relinquished property; and

b) Purchase property equal or greater in value to the property sold. Investors wishing to exchange into a less valuable property (i.e. sell for $500,000, purchase for $400,000) can still utilize Section 1031, but they need to be aware that such a transaction will result in only a partial deferment of the tax liability.

Why Exchange?

Tax Deferral: The primary motivating factor for any 1031 Exchange is the deferral of the capital gains taxes. An investor doing a 1031 Exchange can defer payment of the following taxes:

* 15% Federal Capital Gains Tax;
* 25% Federal Tax rate for the recapture of depreciation; and
* State Tax, if any.

Diversification: In real estate, there are two ways to diversify, by geography and by asset class. If your portfolio is too heavily loaded in one particular geographic area or one particular property type, it may be time to re-allocate some of your holdings. The best way to accomplish this is through 1031 exchange.

Relief of Management Burden: Investors tired of dealing with tenants, leaky roofs and broken toilets, may want to consider exchanging out of difficult to manage properties and into investments that require little or no management. It may also be wise to consolidate numerous difficult to manage properties into one or two easier to manage properties. Triple net lease properties and tenant-in-common investments are just two vehicles available today that offer the investor relief of the management burden.

The U.S. government has provided a tremendous benefit to many investors in the form of Section 1031 of the Internal Revenue Code. As a 1031 exchange qualified intermediary, WaMu 1031 Exchange can provide additional insight into some of the more complex elements of exchanging, such as reverse exchanges, construction exchanges, when to refinance and how long to hold a property before exchanging.

The subject matter is intended as general information only and is not intended as tax or legal advice. Persons with specific tax and legal matters should consult with an attorney, CPA or financial advisor concerning anything that may affect their particular tax and legal positions.

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