

Trading Up Using the 1031 Exchange

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In spite of decreasing real estate values across the nation, real estate investors continue to come up with innovative ways to make their investment turn out profitably.

A powerful method for building real estate holdings is the use of 1031 Exchanges, which lets investors defer capital-gains assessment on investment property by reinvesting sale proceeds into the purchase of new property within a set time period. Though 1031 Exchanges have grown in popularity as the number of active real estate investors has grown, 1031 misperceptions continue. Here are some basic 1031 Exchange questions.

What is a 1031 Exchange?

A 1031 Exchange is a tax avoidance tool that allows you to defer capital gains tax to a later date when selling investment real estate, permitting you to reinvest money from the sale of one property to another. You are, essentially, "exchanging" one property for another investment property of equal or greater value. When the replacement property is ultimately sold (not as part of another exchange), the original deferred gain, plus any additional gain realized since the purchase of the replacement property, is subject to tax.

Why do a 1031 Exchange?

There are three basic advantages to investors in making an exchange:

1. To grow your portfolio: In deferring your tax burden, you are getting an interest-free loan on the tax dollars you might have owed on your property sale. Your immediate tax savings is, thereby, employed instead as investment capital in a replacement property.
2. To convert your "gain" into immediate equity and tax-free cash: The 1031 Exchange provides more equity, which lets you to move up into properties of increasingly higher appraisal every time you perform a 1031. Also, there's another benefit: Once your old property is sold and the succeeding property is purchased, you can turn around and refinance the new property, taking cash out as a loan for anything you want, and the money tax-exempt as income.
3. To utilize as an estate planning tool: Families that intend to pass along real estate holdings typically deed them into a family partnership or LLC (limited liability company). Management income can continue to be drawn from the properties by the parent or principle, but heirs will inherit the property without taxation .and "can continue to 1031 Exchange the property and grow a real estate portfolio," according to attorney David P. Greenberger.

How do I get started?

The opening move is to identify real estate to purchase, and contract to sell your property. Although you can sell your property to anyone you want for an exchange, you must identify in a written document signed by you and executed with a qualified exchange agent, the property you plan to buy within 45 days of giving up your original property. The exchange, or final sale of the property, must be completed within 180 days after the transfer of your property. Sale proceeds must be escrowed in an account with a qualified intermediary, until your "exchange" is complete.

What if you can't locate a property within 45 days?

There are no extensions allowable. So, it is important that you start researching your acquisition as soon as you anticipate your sale is close at hand, and try to time the closings accordingly, since 45 days goes by very quickly.

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Is there a limit to number of properties that are identified in the 45-day period?

You may identify more than one property as a potential replacement property, but be aware of the rules. You can identify up to three properties without consideration to fair market value or you may identify any number of properties provided that the total value does not exceed 200% of the value of the original property sold. You don't have to close on all properties - and you may prefer to identify several just in case the sale of any one falls through. But you must be in compliance with these rules ... or you pay taxes!

Is there a limit to the number of properties I can "exchange?"

You may "exchange" a single property for multiple properties. Or, you can buy a single property from the proceeds of several, as long as all the related timeline, identification and value rules are met. However: proceeds not used to purchase new investment property are taxed as a cash sale. So, if you "exchange" only part of your original sale profits, you will be taxed on the rest.

What are "qualifying properties"?

* Exchanged property must be of "like-kind," which broadly speaking means property of greater or equal value. You can exchange a duplex for a five-story building or even a vacant lot, as long as you meet all other 1031 requirements, including the holding time required before re-selling real estate.

* Property exchanged must be held for productive use in trade, business or investing, which may include a residential rental property, strip mall, warehouse or land held for speculation. Private residences or land in a developer's inventory to sell later are not permissible. It is possible for property purchased in an exchange to be converted at a later date to a primary residence or a vacant lot may ultimately be sold to a developer, but it is tricky. Therefore, it's advisable to consult with a 1031 expert and wait at least two full tax years before to do this.

Trading Up with a 1031 Exchange

It should be apparent, the tax-deferred exchange is a excellent way to build up your net-worth and maximize your investment dollars. There are many more aspects to the 1031 exchange instrument that are not discussed in this article that advanced property investors regularly utilize, such as using them in concurrence with "triple net leases."

However, the regulations regarding 1031 exchanges are complex, they vary from state to state, and are subject to change by the IRS. It's best for property investors of all skill levels to consult with a professional trained in these transactions on a regular basis, as well as with your accountant, before engaging in a 1031 exchange. Once done, you will be able to trade-up on a tax-free basis and accumulate a significant real estate portfolio applying the tax code to your best advantage.

* Excerpted from "Real Estate Flipping: Growing Rich Buying and Selling Property," by Mark B. Weiss, C.C.I.M., published by Adams Media.

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