

FINANCE

Investigate 1031 exchange if planning to sell

Have you done a 1031 exchange yet? If you own appreciated real estate you may want to take a look at section 1031 of the Internal Revenue Code (IRC). That section of the code allows owners of property held as a business or for investment (including real estate) to sell property and defer the gain on the appreciated value into a new property (as long as it qualifies as a like-kind exchange).

So what's the big deal? Well, it all has to do with taxes. If you can imagine buying and holding property over a lifetime — let's just say for 10 or 20 years — you may want to pay attention. Real estate, over its lifetime, will generally appreciate in value. When you sell the property you will owe a capital gains tax which is currently at 15 percent; the lowest level in years. As an example, for every \$100,000 you make you will send \$15,000 to Uncle Sam. If you live in a state with income tax, you will have an additional burden to pay. Iowa, at 9 percent, will add another \$9,000 to your tax bill. (There could be some minor adjustments for deductibility of certain items).

Let's say you qualify for a 1031 exchange; instead of selling your property outright and having to write that check to the IRS, you are going to exchange your property for another real estate property you really like. Maybe you've wanted to sell the farm or the apartment in the Midwest and buy a piece of prop-



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erty in Scottsdale. Assuming you meet the qualifications of a 1031 exchange, you can make the sale/exchange here and invest the proceeds in the new property in Scottsdale. As a result, you reinvest 100 percent of the proceeds into the new property. In effect, you have deferred the capital gain from the old property for a like-kind ownership in the

new property; 100 percent of your proceeds go to work for you in the new property, which should increase your yield. That, of course, is dependent upon what you buy. As a comparison, let's look at two investors with \$100,000 each in appreciation from their real estate investment. Let's assume that both investors wish to place their proceeds primarily in income producing investments and that both investors will hold their investment for 10 years.

Investor A chooses to pay the taxes (we will assume both investors live in Iowa) therefore, Investor A will pay 15 percent Federal capital gains tax and 9 percent Iowa income tax for a total of \$24,000 of the \$100,000 gain. Investor A chooses to invest the remaining

\$76,000 in a fixed income security paying 7 percent annually.

Investor B chooses to defer his taxes by using the provisions of the IRC Section 1031 and exchange his property for another income producing like-kind property.

The following numbers illustrate the difference between selling the old property and paying the tax versus exchanging the old property for ownership in a new property under the 1031 Section of the IRC.

Investor A will receive \$5,320 per year for a total return of \$53,200 or 7 percent annually. Add that to the original investment of \$76,000 and at the end of year 10. Investor A has \$129,200 or an additional gain of \$29,200 over the \$100,000 he started with.

Now let's look at Investor B. Remember that Investor B chose to utilize a 1031 exchange to defer his taxes. Investor B invests his \$100,000 in real estate and because he chose the 1031 route, he does not pay any tax at this time. Investor B's property is paying a 7 percent return annually cash on cash, or \$7,000. At the end of 10 years Investor B has received \$70,000. In addition, real estate will generally appreciate on an annual basis (we have assumed a modest 2 percent annual appreciation rate; your actual results may vary).

At the end of year 10, Investor B chooses to sell the property. With a 2 percent annual appreciation rate the property is now worth \$121,899. Investor B receives an additional \$21,899 above his original investment, plus the \$70,000 in annual income for

an overall rate of return of 8.4 percent. You can see the large amount of additional value you create by delaying the tax. In fact, Investor A would need to invest his \$76,000 at a rate of return around 12.5 percent in order to equal Investor B's return using the 1031 exchange route (results may vary and all real estate investments carry risks).

Now let's talk about your lifetime and what happens when you decide to sell your property. If choose not to do another exchange you will pay the capital gains tax due. Where it gets interesting is if you die while holding the exchanged property. If you pass away during your hold period your beneficiaries will get a step-up in the cost basis. That step-up in basis will allow your estate to value the property at its current value at the date of death with no capital gains on the property or state income taxes due (please remember that real estate investments are illiquid and may not be readily marketable). You will still have to deal with the estate tax value, but you were going to have to do that anyway.

If you want to compound your returns in real estate and other possible exchange positions that qualify for tax deferral, you may want to look at the 1031 provision of the Internal Revenue Code. In my next article I will talk about methods of acquiring the exchange properties which include direct ownership through TICs.