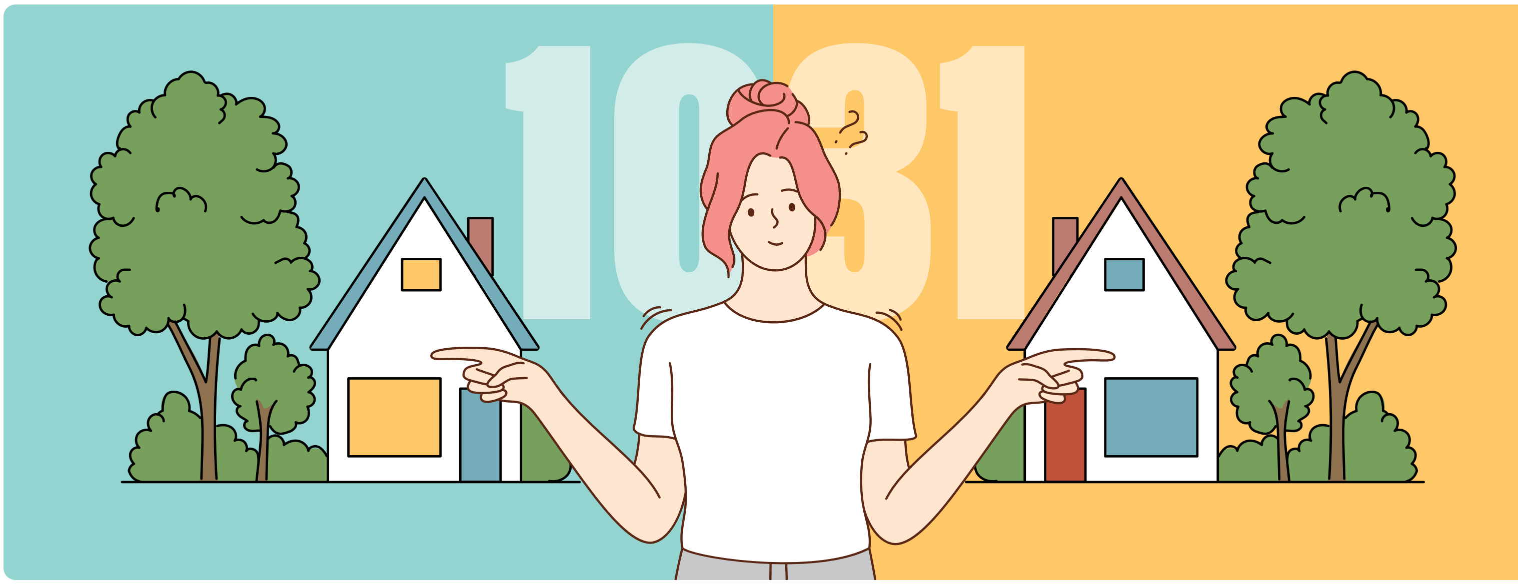
Even Mom-and-Pop Investors Can Profit from This Tax Strategy

Win new business and referrals by becoming a 1031 exchange expert

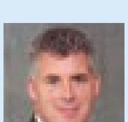
By Joseph Lydon



Home prices remain near record highs — and, as a result, many property investors are sitting on hefty profits. The bad news? Cashing in means triggering capital gains taxes. The federal tax rate on long-term capital gains is up to 20%, and the majority of U.S. states, including California, impose their own capital gains taxes.

For property owners who want to manage their tax liabilities, there is some relief. A 1031 exchange is a type of financing mechanism that lets an investor defer capital gains taxes, so long as the taxpayer rolls the proceeds from one sale into a similar investment property within six months. The flexibility of the 1031 exchange allows investors to diversify their portfolios, upgrade their properties, or consolidate their holdings without immediate tax consequences, providing a valuable tool for maximizing their investments.

The largest, savviest investors have long taken advantage of 1031 exchanges. But small investors can use this tax strategy, too. There are even niche loans emerging to help investors who want to deploy 1031 exchanges. Mortgage originators who understand this program can gain a competitive advantage — and win future referrals.



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Property swap

A 1031 exchange, which is named after Section 1031 of the Internal Revenue Code, is a tax-deferral strategy that lets investors put off taxes when selling an investment property. The seller essentially swaps one investment property for another without incurring any immediate capital gains taxes. It's a strategy that helps investors build wealth over the long term.

Through a 1031 exchange, investors reinvest the full proceeds from the sale into a new property, allowing any appreciation in the value of the property to be reinvested tax-free. This strategy saves money and allows investors the opportunity to continue building their real estate portfolio.

The property being sold, and the property being acquired must be of a "like-kind" — which means both are real estate properties held for investment or business purposes. To defer all capital gains taxes, the value of the replacement property must be equal to or greater than the value of the original property.

Within 45 days of selling the original property, the investor must identify potential replacement properties in writing to a qualified intermediary. The investor must close on the replacement property or properties within 180 days of selling the original property or by the due date of their tax return, including extensions, whichever comes first.

Practical example

Here's an example of how the strategy can work. An investor owns a house in Riverside, California, that they acquired 15 years ago for $250,000. They have been renting the property to long-term tenants. Over the years, the investor has put $65,000 in improvements to the property, bringing the cost basis for the property to $315,000. The house needs a new roof, costing $25,000. Instead of spending $25,000 on a new roof, the investor wants to buy another investment property that does not require major improvements.

The property is now worth $700,000, so it has appreciated by $385,000 over its cost basis of $315,000, putting the investor in a position to pay a significant capital gains tax. Assuming a federal capital gains tax rate of 20%, and a California capital gains tax rate of 7%, the combined capital gains tax would be $103,950. Using a 1031 exchange, the investor trans-fers the $315,000 proceeds of the sold property toward the purchase of the new investment property, deferring capital gains tax.

This strategy even lets the investor buy the replacement property first, while still deferring capital gains taxes on the sale of the original invest-ment property. This is a great option for investors who have found a replacement property but haven't yet sold their original property. The IRS gives the investor 180 days to sell the original property and the funds from the sale are used to repay any loan obtained for the acquisition of the replacement property and to complete the reverse exchange.

Equity possibilities

Now, what if the seller needs to tap the equity in the original property to purchase the new property? Here is where a 1031 exchange strategy using a bridge loan comes into play. To meet this need, some lenders offer bridge loans that allow the investor to access capital by borrowing against the equity in the original investment property. The property this loan is leveraged against must be listed for sale at the time the bridge loan is granted.

By accessing the equity in the original investment property, the borrower can use the capital for a downpayment on the replacement investment prop-erty. Any liens against the original property will be paid in connection with the cash-out refinancing of the property. The remaining funds needed for purchas-ing the new property will come from a purchase money loan on the property.

A final caveat: The IRS has specific rules that investors must follow to qualify for 1031 exchanges. That's not a reason to avoid 1031 exchanges, but it is a reason to make sure you understand the program. It is recommended to consult a tax professional and partner with a lender versed in 1031 exchanges and bridge loans.

DEFINITION

1031 Exchange

A tax-deferral strategy, also known as like-kind exchange, allows people to exchange real property used for business or held as an investment for other business or investment property or properties of the same type. Generally, gains and losses are not required to be recognized under a like-kind exchange.

Source: **IRS**

Empowering investors

Mastering the intricacies of 1031 exchanges not only empowers investors to maximize profits but also positions industry professionals to build last-ing relationships and secure valuable referrals. By expertly guiding clients through these tax-deferment strategies, industry professionals can also offer tangible value, enhancing their reputation and solidifying their role as trusted advisers.

This proactive approach not only strengthens client relationships but also cultivates a sense of loyalty and satisfaction, leading to increased referrals and a broader network of satisfied clients. Understanding these strategies, whether navigating a traditional 1031 exchange or leveraging innovative solutions such as bridge loans, is essential for anyone looking to thrive in the dynamic world of real estate investment. ●

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