The Art of the 1031 Exchange/2014

Tax Deferred Exchange Primer

A Quick Guideline to the Art of the 1031 Exchange/2014

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The New Year is a good time to re-visit the recent developments in the Capital Gains rates that were established in 2013. In essence; as predicted for years, the Federal Capital Gains Rate is "inching up" for high net worth investors from 15% to 20% and the State is adding another 3.8% from its current rate of 9.3%. These dubious factors (income levels, health care insurance costs, and mental health costs) that loom large in the background are positioned to accelerate capital gains ratios upwards to over 35%. This is a big shift from the old standard "rule of thumb" that was approximately 25%, and there is more reason than ever to re-visit the 1031 Exchange Option that is alive and well.

The 1031 Exchange Option still requires an Investor to identify their potential replacement properties within 45 days of the Close of Escrow of their current property; and actually complete that purchase within 6 months of the Close of Escrow of that underlying property. So, you have approximately 4.5 months to actually purchase a replacement property after the 45 day identification period expires.

On the surface; these arbitrary time frames (as dictated by Congress) may appear to provide an investor adequate time to

re-position real estate equity, but my experience tells me that these time frames are woefully inadequate.

The biggest looming pitfall to orchestrating a 1031 Exchange is that initial 45 Day Identification Period. These stringent, unyielding identification requirements require the investor to spend some introspective time evaluating what they want to buy before they decide to sell.

The most common error is waiting too long to begin/define a new property search. I have seen investors languish with a property search and wait until the 45th day to identify 3 properties that just appear to be a reasonable investment.

This approach is just fraught with peril. Often, the Due Diligence Process has not even been initiated, and the property not vetted for acceptability.

How many times has an Investment Prospectus contained a significant error and/or a glaring omission that significantly changes the property's desirability? It is such a common cliché, yet it still remains common for investors to identify a property in an Exchange that has not been significantly investigated.

In my humble opinion, the search for a new property really begins even before you market your existing Investment.

It is so important to acquaint yourself with the Investment arena you desire, research the market you want to explore, know the reasonable expectation for the new cap rate, safety of principle, any lending/loan requirements, tax implications from your accountant, and/or any prepayment penalties.

I have personally witnessed some of the following consequences of waiting too long to begin a replacement property search:

1. You nominate a property in your exchange that is no longer available.

2. The Due-diligence process reveals a Cancellation Clause in the primary lease “no one” knew about (I know this sounds ludicrous, but I have seen it happen)

3. You discover there is a significant environmental issue that was not initially disclosed.

4. The building has some latent defects that were not known when the Investment initially hit the market.

5. There is *mold damage* that was not discovered until deep into the inspection process.

I was once representing a client, and as we were finishing up the Due Diligence Process, we discovered that the nearly new 5 year old building never received an Occupancy Permit from the local Municipality. The building had had a tenant for over 5 years. Really!!!

I think I have made my point. I am not panning the Exchange Process. Quite the opposite. Capitalizing on long held equity through the Exchange Process is still one of the last remaining wealth building options in this country. It can protect your estate and your assets from the “Government Tax Shave,” and expedite building wealth through Real Estate Appreciation. You can take advantage of the depreciation available and interest deductions.

The key is understanding the process, allowing careful planning and preparation to save a lot of “heart-burn” and deliver the financial rewards you have worked for. It’s the “devil is in the details,” and that’s what you can avoid by planning ahead.

An Ounce of Prevention is Worth a Pound of Cure

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