1031 exchanges increasingly attractive as real estate prices climb

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Section 1031 of the IRS Code may seem like an arcane — and perhaps even unnecessary — subject for an adviser to be expert in. But now that property prices have risen to pre-2008 levels in most parts of the nation, it is essential to know about 1031 exchanges, according to Steve Dudash, president of Chicago-based IHT Wealth Management.

“If you are not able to hold conversations about like 1031 strategies with your clients, you are obsolete,” Dudash says. “You won’t have a job in five or 10 years.”

(Bloomberg News)

Knowing about 1031 exchanges is especially valuable for an adviser with clients who own rental real estate. Under this section of the tax code, clients can defer the federal government's recognition of capital gains on the sale of a property if they buy a comparable property — one rental home for another, for instance — within a prescribed time period.

Only recently, as real estate prices have risen nationwide, have 1031 exchanges re-emerged as an extremely useful tool, Dudash says. When clients had properties that were underwater, capital gains taxes were not even a hint on the horizon, he says.

The attractiveness of 1031 exchanges might be amplified if proposals for a flat tax become serious. If such a proposal were to be enacted, clients' capital gains may no longer be taxed at preferential rates but rather would fall into ordinary income brackets, according to Chad Smith, a wealth management strategist at HD Vest investment Services in Irving, Texas. "It could be changing very much over the next year and capital gains could be taxed at ordinary income rates," he says.

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OFFSETTING HANDSOME GAINS

But even under current tax laws, 1031 exchanges are an attractive tool for advisers in an economic environment in which clients are realizing significant capital gains. “It’s always handy,” says Lisa Detanna, a senior vice president and managing director for Raymond James Global Wealth Solutions Group in Beverly Hills, California.

According to Detanna, a client will call and say, ‘Oh, by the way, I’ve sold a property.” In some cases, this can lead to a scramble to find a place to exchange. For just such situations, Detanna turns to a banker whose institution has the designation to act as “a qualified intermediary” in 1031 exchanges.

1031 exchanges are an attractive tool for advisers, says Lisa Detana of Global Wealth Solutions Group.

Under a typical 1031 exchange scenario, a client who owns rental real estate sells the property but the proceeds initially go to such a bank, which is prepared to serve as a qualified intermediary or, as it is sometimes called, an accommodator. Under the IRS rules, the seller of the rental property then has 45 days to identify a "like" property and 180 days to purchase it, using the proceeds that have been kept with the qualified intermediary.

Although an intermediary adds an expense, the tax savings may be much greater. The exchange can help postpone taxes on highly appreciated properties that clients want to sell but don't want to add to their tax bill.

"Some will charge a flat fee, and some charge a percentage of the sale price," Detanna says. But, either way, "it's nominal when consider how much you are saving by delaying the taxes." Indeed, the tax saving put her clients in "a whole different arena" in terms of their purchasing power for a new rental property. "The delay of taxes lets you build wealth," she says.

DEFINING 'LIKE'

The exchanges are possible in a variety of circumstances because of how broadly the tax law defines a "like" property. There is tremendous flexibility in the term. "It doesn't have to be apartment to apartment," Detanna says. "You can switch to a duplex or exchange to a strip mall. It doesn't have to be residential."

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For Smith, 1031 exchange strategies have enabled him to help clients who are "tired of being landlords." For such clients, Smith has frequently recommended that they consider limited partnerships that own rental real estate. These partnerships aim at providing turnkey solutions for investors who don't want to look for another sole-ownership property or haven't been able to find one yet. But when evaluating limited partnerships — sometimes structured as tenancies in common — advisers should approach the proposals with skepticism, Smith says.

"Our firm works with only two vendors" of such vehicle, he says, in order to do business only with firms in which it has confidence. Even then, his firm hires an outside counsel to review any new investment packages the vendors offer. "We are very, very cautious," Smith says.

"That turnkey option is not right for everybody," he adds. "It needs to fit into their overall plan and their income needs."

For her part, Detanna generally steers clients away from the turnkey 1031 investment vehicles. “There are lots of negatives associated with these,” she says. “You have no control; general partner fees are usually high. You are in a partnership maybe with 35 other partners and you get very little information about them or the management of the assets.”

ESTATE PLANNING

On the other hand, one-to-one 1031 exchanges are valuable for clients’ financial planning and, in particular, estate planning, Detanna says. “If the patriarch and matriarch have multiple rental properties and the adult kids don’t have the bandwidth to be in the property management business, 1031 options are something we would generally discuss,” she says.

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Sometimes, since the heirs will get the step-up in property values when they inherit rental real estate, the best option is to wait and allow them to sell it and avoid more expensive strategies, Detanna and other advisers says.

At IHT Wealth, Dudash says his first question to clients considering a 1031 exchange is “What is your purpose?” By knowing their end game, he can help them figure out if such an exchange makes sense in their circumstances.

Sometimes, a 1031 exchange strategy can help with multigenerational planning. A rental property owner can make an exchange to buy a home for an adult child or an elderly parent who then pays rent. This can be an attractive option because no one has to pay capital gains taxes. But, Dudash cautions, often the family dynamics overwhelm whatever rental payment structure is devised and relationships turn sour. “It doesn’t always work out,” he says.

Another scenario in which a 1031 strategy might help, as long as clients have two years of lead time, is in financing a summer home or future residence. If the clients have a rental property, they can sell that and exchange it for a home in a vacation spot of their choice and then rent that vacation property for two years, so they satisfy the IRS’ requirements for the 1031 exchange. After that, the place is theirs to enjoy forever after — no capital gains tax payments required.

But the devil is in the details. According to Alan Soltman, a CPA with Merlis, Soltman, Green & Associates in Los Angeles, who works with Detanna, the IRS will not challenge that the dwelling qualifies as a like exchange under 1031 if it is leased at least 14 days at a fair rental in each of the first two years after the exchange.

But if the clients use the home during the two-year holding period, limitations apply. For a 1031 exchange, the property owners' personal use cannot exceed the greater of 14 days or 10% of the total number of days the property was rented at a fair market price, Soltman says.

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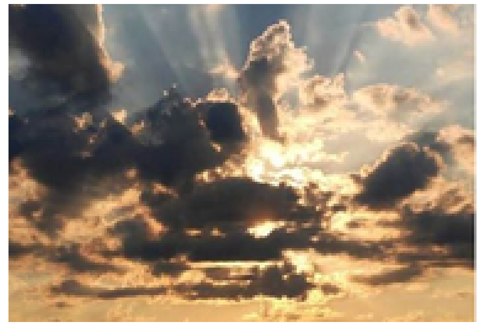

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