Tax-free Real Estate Investing

LUCRATIVE OPPORTUNITIES AWAIT THE SAVVY SALES PROFESSIONAL WHO UNDERSTANDS THE INTRICACIES OF SECTION 1031 EXCHANGES

BY ANNE RANDOLPH

AN INTERVIEW WITH DAVID GREENBERGER OF 1031 EXCHANGE ADVANTAGE

ILLUSTRATION BY BRIAN STAUFFER

Although not necessarily complicated, Section 1031 exchanges are powerful tools for both real estate sales professionals and their customers. However, correct execution is a must, as improper handling of a 1031 exchange can have serious consequences. Sales professionals who understand and assist their clients through the process find that the benefits can be numerous.

A 1031 exchange is simply an Internal Revenue Service code provision that allows one to buy, sell and get cash out of real estate without owing any money in taxes – no matter how big the gain. The major qualification is that assets must be held for investment or business purposes, and both the buy and sell transactions must be completed within 180 days.

The process also requires an intermediary who "holds" the sale proceeds between transactions to avoid what the IRS calls "constructive receipt" of the money, meaning something else could be done with it, which would make it taxable. Basically, says David Greenberger, president and CEO of 1031 Exchange Advantage, Inc., "If you touch the money, you owe the taxes."

Greenberger suggests that less than 5 percent of all real estate sales professionals really understand the power of 1031 exchanges in residential real estate – from investment properties to reverse exchanges (buying before selling), and even home office exchanges. But the intricacies of the 1031 exchange can provide a great deal of opportunity for the savvy sales professional.

For example, vacation property that is rented and used less than two weeks for personal use during the first year can count as investment property and qualify for the favorable tax treatment of an exchange. After the first year, the property can be used as much as desired without running afoul of the 1031 exchange regulations. For a client who simply wishes to take

EDITOR'S NOTE

David Greenberger is the founder of 1031 Exchange Advantage, Inc., a company specializing in IRS Section 1031 exchanges, which was recently purchased by Vineyard National Bancorp. Prior to founding his company, Greenberger spent 15 years as a real estate attorney in New Jersey – where attorneys do all real estate transactions. In 1999, Greenberger moved to California and purchased an escrow company with a small 1031 exchange division. He built both businesses but after five years, sold the escrow company to focus on 1031 exchanges.

some cash out of a trade from one property to another, the exchange is completed first, and a cash-out refinance on the new property achieves the desired result.

Greenberger, who now lives in California, knows about the issues with super-appreciated home values. When asked how a 1031 exchange could be used to offset some of the taxes that might be due when a homeowner downsizes, Greenberger acknowledges that difficulties sometimes arise in high appreciation areas of the country.

If, for example, clients have a super-appreciated home, the $250,000 or $500,000 tax exclusion available to homeowners on the gain when a home is sold may not be enough in these circumstances. If a home was purchased for $100,000 and is now worth $1 million (not uncommon in California), even the $500,000 exclusion may not be enough.

However, sellers can avoid a tax event if they first borrow money out of the existing home's equity to place a down payment on a new, smaller home, and rent their existing home for one year. (They can use the rent on the old home to pay the mortgage on the new one.) This makes the old home a rental property. After one year, they can sell their old home (rental property), pay off the mortgage on that property and exchange their equity into an investment property. They end up with a smaller home and an income-producing property without having to pay taxes in excess of the exclusion on their old home.

Greenberger warns that it is best to identify a trustworthy specialist in 1031 exchanges because the tax laws can be tricky, and there are several specific requirements. It is also best to check the reputation, references and financial stability of 1031 exchange companies. Unfortunately, there have been cases where people who escrowed their net proceeds from the property they were selling with an intermediary (required) later found that the intermediary had absconded with the money.

When asked why most financial planners don't talk about real estate as part of their portfolio, Greenberger says, "Because they don't get paid when they recommend investing in property." Real estate professionals, however, do get paid when clients invest in property, and agents who educate themselves about the possibilities of a 1031 exchange and develop a network of specialists in this area cannot only serve their clients better, but may be able to uncover new business.

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These sales professionals are in the best position to help clients recognize the potential of an exchange, if appropriate, and to get them started in the right direction. As Greenberger says, with real estate – unlike stocks, bonds and financial instruments, where sellers will have to pay taxes some time – "you can avoid taxes forever."

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