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Why is section 1031 virtually unknown to the right coast, when it is so well known on the left coast?

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The history of the tax code pursuant to IRC section 1031 is striking when viewed against one simple critical factor that runs through real estate: Real Estate is a local business. In some ways this explains why a Federal Tax Code called Section 1031, which has so much value for investors, has not found its way into the common every day transactions that occur on the East Coast of the United States of America. On the West Coast, 1031 exchanging is far more prevalent. Section 1031 allows investors from both coasts to defer all state and federal capital gains taxes including depreciation. Why is it being used so advantageously and differently on the West Coast? Isn't deferring taxes and reallocating your real estate portfolio to achieve maximum return with the least amount of tax bite as important to Easterners as Westerners? The answers are as much cultural as they are marketing oriented when we take a closer look.

While it is a Federal Tax Law, the Federation of Exchange Accommodators has always been located in California. This trade organization has done a very good job in marketing the value of exchanging to the local real estate communities. As more realtors began to understand its asset, they began to suggest exchanging as a way to increase transactions.

Although, people think of accountants as sources of good tax information in the 1031 exchange category, accountants are more recorders of information post transaction than promoters of the actual event. However, West Coast accountants in general have been more accepting of exchange transactions when asked about it by their clients due to the information presented from trade groups and the realtors.

Now, 3000 miles eastward where the hot dogs, pizza, bagels and Chinese food are generally better, the scene is completely different. The 1031 diet is more filled with fear, uncertainty and doubt (FUD) than in the west. The reasons are simple:

1. Realtors on the East Coast were never exposed or educated about Section 1031.
2. East Coast accountants are more fearful and unfamiliar with 1031 than their west coast counters as a result of the lack of familiarity with the transactions.
3. Attorneys (The East coast has far greater attorney closings than the west) are less likely to suggest it, or endorse it for the same reasons.
4. Culturally there seems to be a different attitude amongst East Coast investors as to the likelihood of concluding an exchange successfully due to the longer times tables it takes to conclude real estate transactions than in the West. This is generally true, due to the fact, that people are more cautious in general. Also, attorneys do not tend to be sales oriented or driven.

Remember, in life there are two certainties: death and taxes. But with 1031 exchanges, death becomes the only certainty! There's a happy thought!

This moment in United States, real estate history is worth noting. Never before have US real estate investors acquired and stood with so much appreciation in real estate in such a short period of time (1994-2004). Never before, has the tax code as it relates to section 1031, been so straight forward and simplified for the real estate investor to sell property, recognize gain and roll that gain into a new property without the tax bite.

Why now? What is so special about this point in history that should unleash an unprecedented amount of 1031 exchanges?

When income taxes were first enacted in 1918, Public Law No. 65-25440 stated that loss and gain would be calculated on all sales of property. In 1921, during the 67th Congressional Session, Congress enacted section 1031 and it remained relatively unchanged for nearly 60 years.

For the sophisticated investor, with a slew of tax and accounting professionals on hand, the law was used aggressively with transactions requiring an attorney opinion letter to bless the validity of the transaction and allow the tax payer to defer taxes on the sale. This allows substantial advantages to an investor. He can trade up, using someone else's money, the banks, and he can shelter taxes due, by deferring them on an ongoing basis using Section 1031.

By sheltering the gain, and deferring all state and federal taxes, he is able to unlock the biggest impediment to a high rate of return: excess equity.

Prior to 1990, regulations were complex in the tax code concerning many of the surrounding 1031 exchanges and it was prudent to obtain an attorney opinion letter. The grey issues subsided and the cloak and dagger obscurity changed dramatically with the Omnibus Budget Act of 1990. Since 1996, we have experienced the greatest increase in property values in many major real estate markets across the nation. In many cases property values have doubled since 1995 and in some cases only in the past three years. When these properties are transferred, they will account for some of the largest capital gains to be created in the history of the real estate market.

Although it remains a Federal Law, Section 1031 is virtually unknown amongst East Coast investors. Let us do what we can to get the word out from coast to coast. Let us work on keeping Section 1031 at the forefront of our real estate portfolio planning process. Through Section 1031, all in the industry and especially the investors, will profit with this in mind!

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