

Basics of 1031 Exchanges

Today many investors often exchange their investment properties to avoid paying federal and state capital gain taxes. This exchange often requires the involvement of a qualified intermediary or 1031 Exchange Company to avoid constructive receipt. Otherwise your transaction may not be qualified for 1031 tax-deferred exchange. This means the exchange company will keep all of the funds from the properties you just sold when you are looking for a replacement property to complete the exchange. However, many investors do not know these companies are in a business that is not regulated by both the Federal government and any of the 50 states. So technically, these exchange companies can use your money to invest in anything they want. Occasionally there have been sad stories about exchange companies losing investors money and then declaring bankruptcy. Investors can only recover a fraction of their money. On top of that, they may have to pay capital gain taxes because they do not complete the transaction within 180 days! So how do you avoid being a victim?

To answer this question, you will need to understand a little bit about the exchange business, the fees structure as they may influence your decision on choosing an exchange company. Most exchange companies make money by charging a fee per transaction. They also make money on the difference between the money they earn from the investment of your money and the interest they pay you. There are 3 main types of exchange companies:

1. Some exchange companies are just division or subsidiary or an entity owned by an escrow company. For example First American Exchange Company (FAEC) is separate Limited Liability Company (LLC) owned by First American which is also in title & escrow business. FAEC occupies the same office and even has the same phone number as the First American Title office.
2. Some banks, e.g. Washington Mutual (Wamu) also offer 1031 exchange service.
3. Companies that specialize on 1031 exchange. They could be a single-location company or a franchise with offices in many states. For example:
 - Equity 1031, LLC; www.equity1031.com.
 - Equity Preservation, Inc.; www.equitypreservation.com.

The fees charged by these companies vary from \$200 to \$750. However there are different restrictions:

- The company that charges low fee (Wamu charges \$200) often does not pay interest on your fund or only pays interest if your fund is above a certain amount. If your sales proceed is significant, e.g. several hundred thousand dollars, you may save on the fee but may lose a significant amount on the interest payment.
- Some companies may offer to pay savings account rate while another may pay higher money market rate.
- Some companies charge higher fee, e.g. First American Exchange charges \$750, but may allow you to make as many offers as you want. Each time your offer is accepted, the exchange has to review the contract, and wire the money to the seller's escrow account.

To ensure your money is safe, you should ask the exchange company if:

- Your money is deposited in the general account or separated trust account under your name. When the money is in the general account, the exchange company can use it for anything; e.g. pay salary for its employees. Should the company declare bankruptcy, all of your money could be lost. On the other hand, the trust account is

intended to keep your money just for own use. This kind of account is regulated by the federal government and the exchange company cannot use money for its business. So this is a safe account to keep your funds. Normally if you don't say anything, your money is deposited in a general account.

- Your money is FDIC insured.
- Your money is invested in the US. If it's invested outside the US, there may be a delay from the time you request your money to the time you actually get it.
- Your money is safe. As a general rule of thumb, if the exchange company pays you high interest then chances are your money may be invested in a higher risk investment.

So when you choose a exchange company, you should consider its fees, services, and more importantly if the company is trustworthy enough to keep your money.

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1. How to invest in commercial real estate for retirement income **NOW**.
2. How to maximize cash flow with 1031 tax-deferred exchange.
3. TIC/Syndication: strategy for small investors and self-directed IRA investors to acquire high-valued properties.

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