1031 EXCHANGE SITE
A Canyon Pacific company

An Essential Guide to 1031 EXCHANGES

By Herb Alston

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What is a 1031 Exchange?

The term 1031 Exchange comes from the IRS tax code Title 26, Section 1031.

It's also known as a "Like-Kind" exchange. It was first created in 1921 after being initially adopted by the U.S. Congress as a part of The Revenue Act of 1918.

A 1031 exchange allows an investment property owner to defer capital gains tax, thus freeing more capital for investment in a replacement property. It's a common strategy that investors have used for over a century.

The confusing part is, what does "like-kind" mean? Investors often pace the floor trying to understand – IRS SPEAK. Like-kind, 95% rule, 200% rule, 3-property rule, what's a QI(?), what size boot, why are there so many acronyms. ***OMG!***

CAN SOMEONE SIMPLIFY THIS?

This book will hopefully help you get a better grasp of the acronyms, the details, and the strategies available to you, the investor. For example, do you actually have to buy another property (i.e., apartment building, NNN pharmacy, rental condo)? Answer – No you don't. There are alternatives.

Two most common questions (answered later):

"I want to do a 1031 Exchange with the home I live in, can I do that?"

"I'm selling a rental condo (in Miami Beach, for example), do I have to buy another condo?"

While the basics of a 1031 exchange are not difficult to understand, there are many moving parts to an exchange. It's critical to understand all the details and deadlines before you get started. Don't worry. Many investors have successfully used this strategy. All it takes is a bit of knowledge, the right team to assist you, and plenty of planning.

First: The Benefits of a 1031 Exchange

There are several potential benefits of completing a 1031 exchange. Some of the most common may include:

Tax Deferral

As long as you follow all the rules and meet the required deadlines, performing a 1031 exchange will allow you to defer capital gains taxes on your property sale. This allows you to keep all of your sale proceeds working for you instead of paying a large portion of it to the U.S. government.

Flexible Exit Strategy

Some may want to exchange several smaller properties for one large property or exchange one large property for several smaller properties allowing for a strategic exit strategy. If the latter, you'll have the option to sell portions of your property portfolio over time instead of all at once.

Legacy Opportunities

Today, every individual and family have the opportunity through 1031 Exchange to pass on to heirs their legacy through estate planning.[2]

Wealth Creation[1]

There's no limit to the number of times an investor can complete a 1031 exchange. This means that you can continually trade up, potentially building more equity each time. An investor who begins with a single rental property could keep upgrading to higher-valuable properties, eventually building an extensive portfolio of real estate assets.

Portfolio Diversification

By continuing to hold your investment property and/or successfully engage in a multiple 1031 exchanges, you can defer the capital gains throughout your lifetime. If an heir inherits property or assets, they'll receive the property on a stepped-up basis at fair market value and they generally don't owe taxes until they sell those assets. Heirs then have a choice to continue to exchange that property, therefore, helping to build an even longer-term legacy. Should the heir wish to sell the inherited property or asset; they pay taxes only on appreciation that occurs after they inherit the property, due to the stepped-up basis.[3]

[1] Potential cash flows/returns/appreciation are not guaranteed and could be lower than anticipated.

[2] While every individual has the opportunity to conduct a 1031 exchange, it may depend on suitability and circumstance. Each individual should consult with their tax, legal and financial professionals about their particular situation.

[3] If an heir inherits property or assets, they generally don't owe taxes until they sell those assets. Should the heir wish to sell the inherited property or asset, they pay taxes only on appreciation that occurs after they inherit the property due to the stepped-up basis.

Important Timelines

To successfully complete a 1031 exchange, you must follow the timeline requirements. If you fail to perform the necessary actions by the deadlines, you'll lose out on your opportunity to enjoy deferred taxes and all the other potential benefits of a 1031 exchange.

To make sure this doesn't happen to you, you'll need to follow both the 45-day rule and the 180-day rule. The IRS does not grant extensions on these deadlines, so you must meet them.

45-Day Rule: Identification Period

The first rule states that you have 45 days from the closing date of your sold property or properties (the "relinquished property") to identify the property you plan to purchase (the "replacement property.")

This requirement must be completed in writing, and the document must clearly identify the specific replacement property address and percentage of ownership. This includes providing the street address or the legal description. To meet the deadline, you must provide this document to your Qualified Intermediary ("QI") (more on this later) no later than the end of the 45th day after your original property sale.

180-Day Rule: Closing Period

The second rule states that you must close your exchange within 180 calendar days from your original property sale. The dates run concurrently. For example, let's assume you sold a six-unit apartment building and you closed escrow on June 1st.

Day One - June 1

(Date of Property sale = Closed Escrow = Sold)

Day 45 - July 16

(45th day & Drop-dead Identification (ID) date)

Day 180 - November 28

(End of exchange period – All purchases MUST close by today!)

Like-Kind Properties

Many first-time 1031 exchange investors may be intimidated by the process of finding a "like-kind" property. However, you actually have flexibility.

Under IRS rules, the term "like-kind" is "IRS SPEAK" and refers to the "nature or character" of a property, not the grade or quality. This means that all real estate properties located in the United States are considered "like-kind" to all other types of U.S. real estate properties. In plain English, any property that you own that produces income that you don't reside in as your primary residence qualifies as a replacement property.

Remember that question about selling a condo and buying a condo? Many people think or "have heard…" that they can only buy the same type of property; condo for condo, house for house… and that is what "like-kind means. Not so!

Here are some examples of types of property exchanges that qualify as like-kind:

- A commercial building for a piece of farmland
- A single-family rental property for a hotel or motel
- Raw land for improved real estate
- Industrial property for an office building
- A multi-family apartment building for a strip mall

While this certainly gives you plenty of choices, some rules apply. First, in almost all cases, an investor's primary residence cannot be used for a 1031 exchange. This answers the question as to whether a seller can sell their primary residence in a 1031 Exchange. The answer is no. Investors should speak to their CPA and/or a tax professional to see what potential tax benefits are available in the sale of a primary residence.

Passive Investment Options

There are many potential advantages to investing in real estate. However, managing properties takes time and effort. The good news is, even if you're not interested in being a landlord, you may still enjoy the potential benefits of a 1031 exchange!

IRS rules also allow investors to choose from several passive investment options instead of a physical property, when suitable. What is meant by passive investment? One option is called a Delaware Statutory Trust, often referred to as a DST. A DST refers to a portfolio of real estate that is managed by an institutional or portfolio manager that seeks to generate income, potential, depreciation and all of the same tax advantages of owning and managing real estate without the daily headaches of the tenants, toilets and trash.

A DST is a professionally managed portfolio of properties. This investment works similarly to a limited partnership. The trust itself holds the actual property assets, while each individual investor owns a fractional interest (or shares) of the trust. For example, the DST can own a portfolio of "necessity retail" stores (8 Walgreens, 6 CVS drug stores, 5 Dollar Generals, and 3 Tractor Supply stores spread out over 6 states, for example). Another example may be a portfolio of Self-Storage facilities (2500 units in three facilities, one in Phoenix, another in Atlanta and Houston). A third example could be a 300,000 square foot FEDEX or Amazon Distribution facility.

Owning shares of a DST gives investors the ability to invest in real estate sectors they may not otherwise have access to. Sometimes known as institutional investments. These investments are often illiquid and managed by the sponsor/portfolio manager. Which means it is hands off by the investor. The gift of being hands off is that the portfolio manager makes all of the decisions and when to transition the portfolio. For that long-term active manager, the "tinkerer" who likes being the handy person around the building and the day-to-day management… this takes some adjustment.

Another strategy is a direct investment in a single-tenant, net-leased ("NNN") property. These rental arrangements state that the tenant is responsible for handling all maintenance, insurance, operating expenses, and taxes associated with the property, relieving the owner of much of the hassle involved in property ownership. One issue we have seen with these types of properties is at the end of the lease should the tenant vacate; the investor is now left with an empty property that they either have to re-lease or sell.

Our team primarily focuses on the Delaware Statutory Trust ("DST") strategy, Joint Venture and some custom Tenant-In-Common (TIC) type opportunities for our clients, when suitable.

DST and NNN properties are only available to accredited investors. To qualify as an accredited investor, you must have earned an annual income of at least $200,000 in the prior two years ($300,000 for couples) and reasonably expect to earn the same or more in the current year. Investors who have a net worth of over $1 million, excluding primary residence, also qualify.

Partial Exchanges

When selling your investment property, you may find that you need to keep some of the sales proceeds for another use. The good news is you can still engage in a partial 1031 exchange. In this case, you'll owe capital gains and depreciation recapture taxes on the proceeds you don't reinvest. This taxable portion of the proceeds is known as "boot."

The Role of a Qualified Intermediary

It's important to note that you cannot perform a 1031 exchange by yourself. IRS rules state that to qualify for favorable tax treatment, the investor must never take possession of the proceeds from the sale of the property.

While the simplest form of a 1031 exchange would be for two people to swap their properties, it's doubtful you'll find someone who has the exact property you want and also wants the property you currently have. For this reason, almost all 1031 exchange transactions are "delayed exchanges", meaning the Exchangor relinquishes property before he acquires property.

Since property exchanges don't take place simultaneously and investors aren't allowed to take possession of the funds, you'll need a "qualified intermediary" to assist with the transaction.

Once the property sale is complete, the qualified intermediary ("QI") will hold the proceeds for you until you're ready to purchase your replacement property. Then, they'll use the funds to purchase the replacement property for you.

It's important to be careful when selecting your QI. You'll want to make sure the QI has the necessary experience and qualifications. In addition, the party you choose may not have any other formal relationship with either the seller or the buyer. Choosing your CPA, banker, or professional advisor would cause your 1031 exchange to fail.

Important Challenges to Consider

While there are many potential benefits to a 1031 exchange, they're not without risk. Some of the potential challenges you may face include, but may not be limited to:

Challenge: Tight Timelines

The 45-day and 180-day rules are set in stone. It's extremely rare for the IRS to allow extensions. Although it has happened, it is generally after a natural disaster happens in a specific region of the country.

Challenge: Difficulty Finding the Right Property

While investors have flexibility when choosing a replacement property, the tight timeline can be stressful.

Challenge: Taxation on "Boot"

The most efficient exchange is when the investor matches the equity (cash) and the debt (loan). This means if your exchange is $500,000 and you have paid off a $100,000 loan your new purchase should be at least $500,000 and include a replacement loan of at least $100,000, for example. I have often received a call, "I just closed escrow, there is $400,000 with the Qualified Intermediary." My first question is always, "What was the sale price of your sold property?"

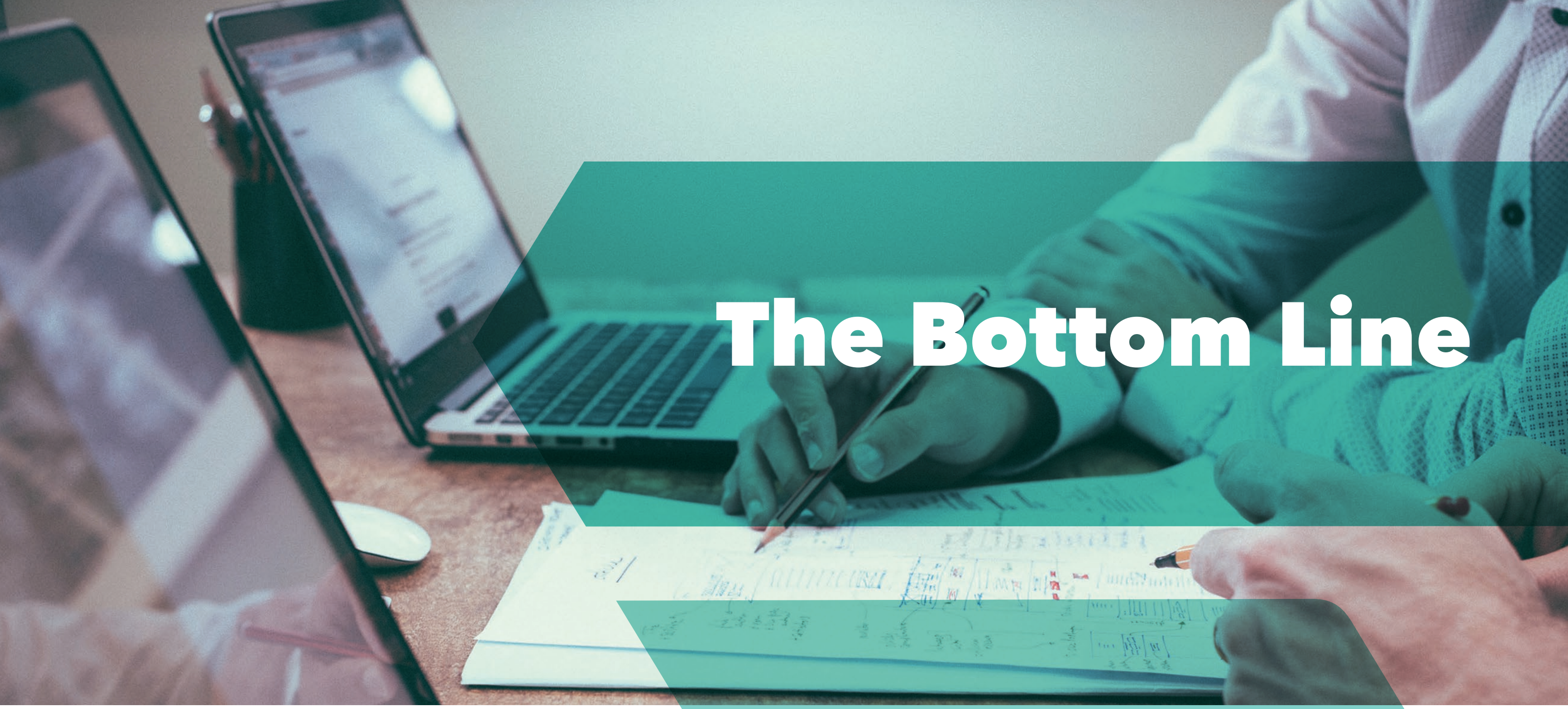
To enjoy full deferral on your capital gains taxes, both the purchase price and the mortgage balance on the replacement property must be equal to or greater than that of the relinquished property you sell.

If you purchase a replacement property that costs less than the relinquished property, the leftover money is considered "boot." This money doesn't receive favorable tax treatment and will be subject to capital gains taxes.

The same applies if your new property has a smaller mortgage than the relinquished property. In this case, you'll also need to make sure you have enough cash available to pay your tax liability.

Challenge: Future Uncertainty

Deferring your capital gains taxes today is undoubtedly a benefit. However, there's no way to know how high the tax rates will be when you ultimately sell your property. Many of our clients have been comfortable with this risk, however, it is still worth considering before making any investment. This is a risk most investors are comfortable with. However, it's still worth considering.



The Bottom Line

Now that you understand the basics of how a 1031 exchange works and how it can help you make an educated decision about whether it's suitable for you. If you're comfortable with the potential challenges, you may find that the potential benefits are well worth the effort.

If you need more information about completing a 1031 exchange or you're looking for advice regarding finding a suitable replacement property, we're here to help.

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Questions?

Call or email

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to request a no-cost consultation.