The 1031 Tax Deferred Exchange Explained

The words "1031 Exchange" have become commonplace in real estate investing and provide an important vehicle for owners and investors of real estate.

What is a 1031 Exchange?

- In simplest terms, a 1031 Tax Deferred Exchange (also called a "like-kind" exchange) is a method of exchanging real estate, according to certain rules and procedures, so that all or most of the capital gains taxes will be deferred to the future. For owners of real estate, this means you can change or swap out of your current real estate investment without recognizing the capital gain and allow your investment to continue to grow tax deferred.

By taking advantage of the IRS Section 1031 of the US tax code, investors can receive significant benefits versus an outright sale of the property.

- **What are the Benefits?**
  - **Tax Deferral**: A 1031 Exchange allows you to defer capital gains taxes on the sale of your real estate.
  - **Increased Buying Power:** A 1031 Exchange allows you to reinvest 100% of the sale equity by avoiding capital gains taxes.
  - **Potential for Increased Income:** A 1031 Exchange allows the investor the opportunity to reinvest into a potentially higher income producing property.
  - **Management Relief:** Replace a property with significant management and purchase a property that has lower or zero maintenance liability, such as a single tenant, net leased investment property.
  - **Diversification**: Exchange out of one or more investment properties, out of one or more locations, or out of one risk profile to another, to better match your investment objectives and/or capture shifts in the market.
  - **Consolidation**: Sell multiple properties and consolidate your equity into one property
  - **Depreciation**: Potential to increase depreciation. A taxpayer will continue to use their existing depreciation schedule from the relinquished property as the depreciation for the replacement property. By using all capital gains, and mortgaging up, it may produce a greater tax shelter and depreciation for the taxpayer. Please consult a tax professional before acting on any advice.
  - **Estate Management**: Investors can execute multiple exchanges throughout their life, deferring the tax liability until death, at which time the depreciated value of the property is "stepped-up" to the then current market value. Heirs who inherit your replacement property will benefit from receiving the property at a step-up cost basis equal to the fair market value of the replacement property, at the time of your death. In turn, they can immediately sell it with the possibility of having no capital gain tax liabilities.

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Here are 7 things you should know about selling your real estate and deferring your taxes through a 1031 Tax Deferred Exchange.

1. **Not all real estate qualifies.** Only Investment Property and Business Property qualify for a 1031 Exchange. Other types of real estate such as primary residences, vacation homes, and time shares may not qualify.

2. **A "like-kind" exchange isn't exactly what the name implies.** When originally conceived, the IRS 1031 tax code required a property be exchanged for the exact same type of property. As of the 1990 re-write of Section 1031, it is now legal and common to sell one type of investment property and buy another. A 10-unit apartment building can now be "exchanged" into any other type of investment real estate, such as, vacant land, a shopping center or a single tenant, triple net property.

3. **You can perform a "delayed" exchange.** In fact, the vast majority of exchanges are delayed exchanges, known commonly as a "Deferred Exchange." Generally speaking, the "Replacement Property" that you are swapping into must be 1) identified within 45 days, and 2) purchased within 180 days OR up to the date that year's income tax is due. The benefits of a deferred exchange are that you have much more time and flexibility to structure a sale of your relinquished property to a third party purchaser and structure a purchase from someone completely different up to 180 days after you sold your old property.

4. **You need a "safe harbor" middleman.** In a delayed exchange, you need a middleman to hold the equity after you "sell" your property and before you have closed on the replacement property. This three party exchange is known as a "swap" and the "safe harbor" middleman is known as a Qualified Intermediary or "QI" for short.

5. **You can designate and swap into multiple properties.** The IRS allows you to identify up to three properties as the designated replacement property, so long as you eventually close on at least one of them. Alternately, you can designate additional properties if you stay within certain valuation tests.

6. **Avoid the boot.** Any cash remaining after the purchase of the replacement property from the proceeds of your relinquished property, will be taxed as a capital gain. This extra equity which is subject to taxes is known as "boot." Similarly, you must consider the mortgage on the relinquished property with the new mortgage on the replacement property. If your liability, in this case the debt, decreases, that too will be treated as income to you. For example, suppose you had a mortgage of $1 million on the relinquished property, but your mortgage on the replacement property is only $900,000. The IRS would consider this a difference of $100,000 to be considered capital gain and taxed accordingly.

7. **Repeat.** There is no limit on how many times or how frequently you can perform a 1031 Exchange. You can roll over the gain from one piece of real estate to another. Although you may have a profit on each swap, you avoid paying the taxes until you actually sell your investment outright for cash many years later.