THE 1031 INVESTOR

1031 EXCHANGES

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What are 1031 exchanges, and why do they exist?

Sale of real estate that results in a gain is subject to taxation. If your investment property appreciated in value during your ownership, then that increase is taxable when you sell. In addition, whether or not you took advantage of the available depreciation deductions during the course of your ownership, you will be subject to “depreciation recapture” taxes as if you did when you sell. Unless you utilize a 1031 Exchange.

In 1921, Congress enacted Internal Revenue Code Section 1031 and “1031 Exchanges” were born. Like your 401k or IRA, the tax benefits of a 1031 Exchange are government endorsed and sponsored. And also like your retirement accounts, there are specific rules and regulations you must follow to take full advantage of this assistance for real estate investors.

1031 Exchanges allow for the “exchange” of investment real estate without paying tax on the gain. By selling your appreciated or depreciated investment real estate and purchasing replacement investment real estate while following the 1031 rules and regulations, you will be allowed to indefinitely defer payment of the tax that would normally be due on sale.

The Power of 1031 Exchanges

With a 1031 Exchange, capital gains tax may be deferred when you follow the IRS criteria. Also known as a Starker or Like-Kind Exchange, a 1031 Exchange allows you to reinvest all of your proceeds including the deferred tax into replacement investment real estate of equal or greater value without paying capital gains tax. You use your equity and profit, including the capital gains tax normally due upon sale, to replace one investment property with another.

This significantly increases your reinvestment capital. Paying capital gains tax when you transition from one investment to another reduces your buying power, opportunities for compound growth, and reinvestment opportunities. 1031 Exchanges allow you to harness your own tax dollars to grow your investment real estate portfolio.

The Basic Rules

For your transaction to qualify, you must meet the following IRS requirements:

1. You must use the services of a "Qualified Intermediary" (QI) to manage and perform your 1031 exchange. And your QI must be in place before the closing of your sale. You cannot touch the proceeds of your sale. This means neither actual or constructive receipt of any of the cash or equity from the sale of the old property. Even if you never have the funds in your direct possession, their delivery to your title company or any other entity under your ownership or control nullifies your exchange. Only a QI can handle this money while the exchange is being completed.

2. Both the relinquished (old) and replacement (new) properties must be held for use in trade, business or investment.

3 You have 45 days from the date of closing on the old property to identify a list of properties from which you will purchase the new property. Certain restrictions are placed on this list:

a. If you name three or fewer potential replacement properties, then there is no restriction on their valuations.

b. If you want to name more than three potential replacements, then the aggregate value of all the properties on your list can be no more than 200% of the value of the property you sold.

c. However, if you name more than three properties, and if their aggregate value is more than 200% of the value of what you sold, then you may still complete a valid 1031 exchange as long as you actually purchase at least 95% of the value of the potential replacement list.

4 From the date of closing, you have 180 days to close on one or more of the properties from your 45-day list.

5 The titleholder (taxpayer) on the old property must be the same titleholder (taxpayer) on the new property.

6 You must reinvest all cash proceeds from the sale and purchase a new property or properties of equal or greater value to avoid being taxed on the gains.

Other 1031 Exchange Options

A standard 1031 Exchange is the sale of one investment property followed by the purchase of a replacement property. What follows is a very brief introduction to more complex options available to meet differing investment goals and needs. These can be explored in greater detail during a personal consultation or via our online video series:

- Reverse Exchanges allow you to use your own funds or funding source to purchase a new property before selling the old property while still avoiding the tax hit on the sale.
- Construction Exchanges are structured so that you can purchase a lot and complete new construction using the proceeds from the sale of your old property.
- Improvement Exchanges allow you to purchase properties needing improvement and complete the value-add repairs using your 1031 exchange proceeds.
- Oil, Gas or Mineral Rights Exchanges defer the tax when you transition from one to another of these non-traditional holdings.
- Multi-Asset Exchanges combine traditional (real estate) and non-tradition (oil, gas or mineral rights) in any configuration of sale then purchase.
- Consolidation Exchanges involve the sale of multiple assets into one large purchase of equal or greater value to all those sold.
- Diversification Exchanges allow you to purchase multiple smaller assets with the proceeds of a large sale so long as the value of the replacement properties is at least as much as was sold.
- Complex Exchanges address indebtedness from the sale of the old property, such as trust issues or installment notes, as well as divorce issues and land contracts.
- FIRPTA or the Foreign Investment in Real Property Tax Act of 1980, Exchanges allow for the deferral of capital gains taxes by foreign nationals with real estate investments in the United States when they follow the prescribed IRS requirements.

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Nationwide Qualified Intermediary
for 1031 Exchanges

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