Using a 1031 Exchange

TO DEFER CAPITAL GAINS ON REAL ESTATE INVESTMENTS

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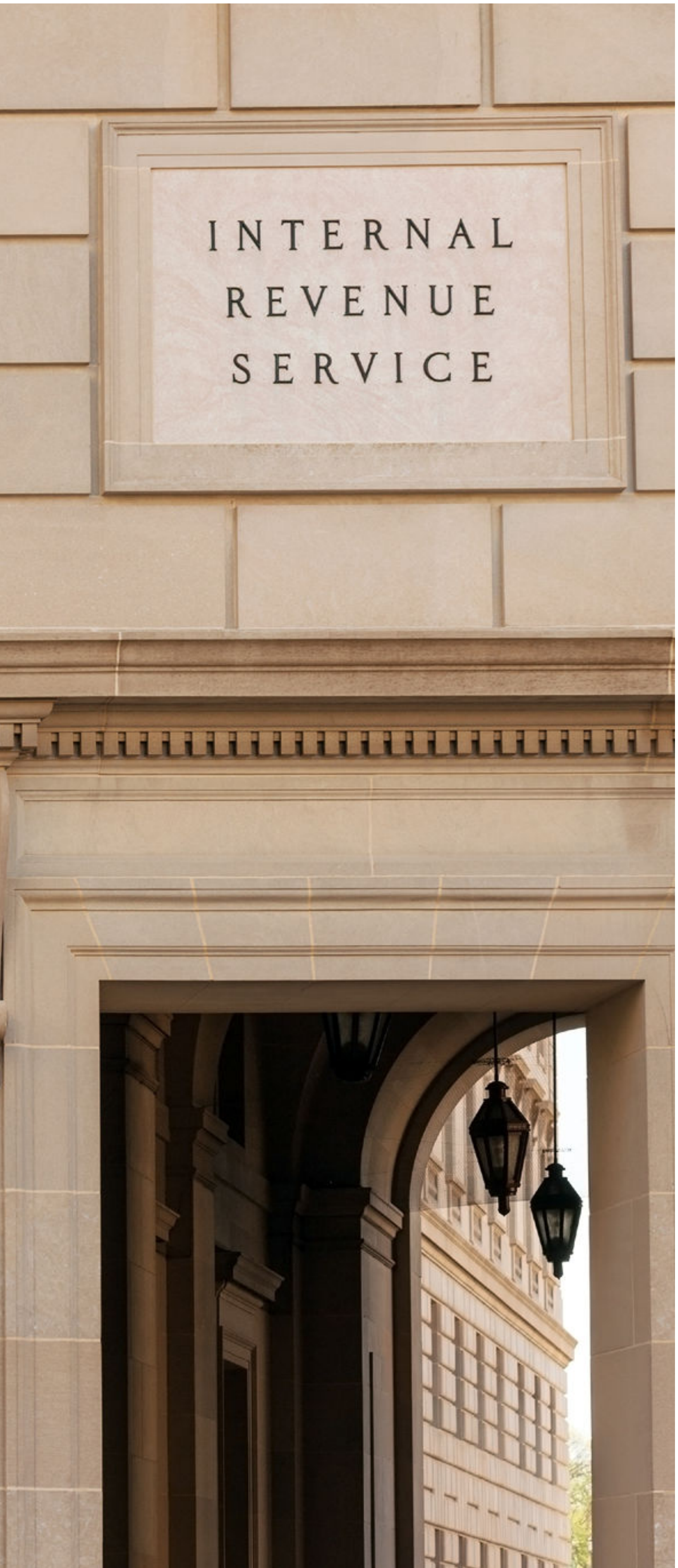

An opportunity to defer taxes can be worthwhile, and if you have a real estate asset outside of your primary residence, you should be aware of a 1031 exchange. A 1031 exchange, also referred to as a like-kind exchange or a Starker exchange, allows the seller of real estate to postpone the payment of capital gains taxes by effectively swapping their current property for one or more properties of equal or greater value.

Capital gains taxes can eat into your profits from selling real estate, especially if you are selling multiple properties. To highlight the potential benefit, consider that in 2005, the IRS recorded $101.3 billion in deferred capital gains taxes.[1]

There are several considerations to keep in mind when performing a 1031 exchange, and the IRS pays close attention to taxpayers who employ this strategy. To ensure that you stay within the law and don't run afoul of the IRS, it is important to know when a 1031 exchange can be used and the required process.

Important
Primary residences and vacation homes are not eligible for a 1031 exchange

Cases for Implementing a 1031 Exchange

Before examining the specifics of using a 1031 exchange, it is important to understand the various use cases and limitations. For a property to qualify for a 1031 exchange, it must be held for use in a trade, business, or investment. It cannot be a property held for personal use, such as a primary residence, vacation home, or property held solely for resale. Furthermore, the property must be situated within the United States, and it must be exchanged for a property of like-kind.

The most common case for implementing a 1031 exchange typically involves an individual investor who is looking to upgrade their property to one with better return prospects. Other common situations involve changing one property into many and consolidating many properties into one.

A less-common scenario also exists within partnerships. Although partnership interests cannot be exchanged, the partnership itself can make the exchange in what is referred to as a drop-and-swap 1031 exchange.[2] In this type of maneuver, the 1031 exchange allows for easy dissolution of the partnership in the future.

Whether it is an individual or a group performing the exchange, there are four types of 1031 exchanges that exist:

- **Delayed:** The most common type of 1031 exchange. One property is sold and then a new property is acquired within 180 days.
- **Simultaneous:** Properties are exchanged at the same time.
- **Reverse exchange:** The new property is acquired first, and then the relinquished property is sold.
- **Improvement:** Allows the deferred taxes to be used toward improvements on the acquired property.

When You Wouldn't Want to Use a 1031 Exchange

Although deferring taxes may seem like an advisable strategy, there are instances where it is better to forego the 1031 exchange. The most obvious situation would be when the property is being sold for a loss. In such a case, it is better to utilize the loss to offset gains from more profitable investments. Similarly, if you have other investments that have taken losses, you may wish to recognize the gain from the sale of property to offset those losses.

Your tax liability also needs to be examined, and if you can make the payment without much financial strain, then realizing the gain may make the most sense. Taking the immediate profits

is also beneficial when you require immediate liquidity or wish to make an investment elsewhere, such as in a business, stocks, or a piece of real estate that is not a like-kind. Finally, using a 1031 exchange for the sole purpose of deferring taxes may not be the best use case. If you are unable to find a suitable property to acquire, it is typically best to make a traditional sale, rather than exchange it for a property that isn't a good investment.

Remember

Deferring taxes isn't always the best option. If you can't find a suitable exchange property, it is sometimes better to make a traditional sale.

Successfully Using a 1031 Exchange

Each type of 1031 exchange has unique rules, and completing the process incorrectly will negate the potential tax deferral. To make sure that the exchange is completed correctly, you will need to enlist the help of a qualified intermediary. A qualified intermediary is a person or company who works in a capacity to sell your relinquished property, purchase the acquired property, and then transfer the deed to you.

The services of a qualified intermediary are necessary to avoid the realization of capital gains taxes, as they hold the proceeds from the sale in escrow and facilitate the exchange. If you were to take possession of cash from the sale at any time before receiving the deed to the acquired property, the terms of the 1031 exchange would be violated and you would be on the hook for paying any capital gains taxes.

In addition to facilitating the exchange of properties, a qualified intermediary is responsible for filing the appropriate paperwork and meeting required deadlines. Two deadlines must be met for the 1031 exchange to be executed.

- **45 calendar days after closing on relinquished property:**
  Potential replacement properties must be identified in writing, signed by the 1031 trader, and delivered to a person involved in the exchange, usually the qualified intermediary. The replacement property needs to be clearly described in the documentation and include a legal description, street address, or distinguishable name.

What is Like-Kind?

The IRS defines a like-kind property as a property of the same nature, character, or class.[3] In reality, most real estate property qualifies as like-kind, and the quality or grade does not matter. Here are some examples of what would qualify.

- Vacant land for an apartment complex
- An apartment building for an office park
- A condo rental for a single-family rental

- **180 calendar days after closing on relinquished property:**
  Or the due date (with extensions) of the income tax return for the year in which the relinquished property was sold, whichever comes first, is when the exchange must be completed. The acquired property must be substantially the same as the one identified in the 45-day limit. This is also referred to as being 'like-kind'.

Hiring a Qualified Intermediary

Hiring a qualified intermediary is a necessary step in completing a 1031 exchange, and a great deal of thought should be put into picking the correct entity to handle the exchange. The qualified intermediary will be trusted with large sums of money, is responsible for meeting deadlines, and will need to file the appropriate paperwork. Making the wrong choice could disqualify the entire exchange.

When looking for a qualified intermediary, it is recommended that you seek a trusted source with real estate experience and a track record of completed exchanges. More importantly, there are limitations on who cannot act as a qualified intermediary. The limitations include anyone who has worked for you in any of the following capacities within two years of the sale of the relinquished property: real estate agent, broker, investment banker/broker, accountant, attorney, or employee.[4]

There are also schemes that you should be wary of. Steer clear of any intermediary who encourages you to exchange non-qualifying properties, refers to the exchange as "tax-free" instead of "tax-deferred", or advises you to claim an exchange after you have already taken possession of cash proceeds from the sale. These are all indications that the person or company with whom you are working is unqualified for the task.

Two Years Before the Sale

The amount of time required before anyone who has worked with you as a real estate agent, broker, investment banker/broker, accountant, attorney, or employee can become your qualified intermediary.

Consider a Delaware Statutory Trust (DST) 1031 Exchange

For investors who would like to take a more passive route with managing their real estate investment, it is worth considering a DST 1031 exchange. Similar to an exchange fund, using a DST 1031 exchange allows the investor to gain partial ownership of a trust which invests in a diverse portfolio of real estate properties. This enables the investor to potentially mitigate the risk of holding a concentrated position while alleviating the day-to-day stress of property management.

Despite the benefits of using a DST 1031 exchange, it is not right for every situation, and it carries certain drawbacks. Due to the nature of trusts, liquidity is a primary concern, and you may run into difficulties when passing your investment along to an heir. You also lose a significant amount of control over the investment properties.

Reporting the 1031 Exchange to the IRS

Special care must be taken for taxes filed for the year in which the exchange occurs. When filing, you will need to use tax form 8824, and failure to follow the procedure may cause you to be held liable for taxes, incurred penalties, and interest on the transaction. Selecting a trusted tax advisor will help you with the process, but you should be prepared to provide the following information:[3]

- Descriptions of the properties exchanged
- Dates that properties were identified and transferred

- Any relationship between the parties to the exchange
- Value of the like-kind and other property received
- Gain or loss on sale of other (non-like-kind) property given up
- Cash received or paid; liabilities relieved or assumed
- Adjusted basis of like-kind property given up; realized gain

Determining if a 1031 Exchange is Right for You

Deferring taxes with a 1031 exchange is a complex process with strict deadlines, requirements, and procedures. All tax-paying entities qualify for a 1031 exchange, but the exchange can only be used on properties held for use in a trade, business, or investment. Completing a 1031 exchange carries risk, especially where deadlines are concerned; however, the benefits of deferring taxes while acquiring a new property are alluring.

There are also possible tax implications that must be considered before planning to use a 1031 exchange, which, among others, include capital gains for leftover cash, differences in mortgage among the properties, and unsuccessful sale of relinquished property.[5] To fully understand the risks and mitigate tax implications, it is recommended that you seek the help of a qualified intermediary as well as a trusted financial advisor.

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