The 1031 Exchange

The term 1031 Exchange (aka a "Starker exchange" or a "Like Kind exchange") is defined under section 1031 of the IRS Code. (1) To put it simply, a 1031 exchange allows an investor to "defer" paying capital gains taxes on an investment property when it is sold, as long another "like-kind property" is purchased with the profit gained by the sale of the first property. We'll discuss like-kind property in more detail in section four.

Brandon Turner from Bigger Pockets explains that a 1031 exchange has more benefits than just saving yourself from taxes.

According to Brandon, a 1031 exchange *can allow a real estate investor to shift the focus of their investing without incurring the tax liability. For example, perhaps you are investing in properties that are low-income and thus high-maintenance. You could exchange the high-maintenance investment for a low-maintenance investment without needing to pay a significant amount of taxes. Or perhaps you want to move your investments from one location to another without the IRS knocking. The 1031 makes this possible. (2)*

Note: Traditionally, a 1031 exchange is where one property is literally swapped for another property of like-kind. However, the likelihood that the property you want is owned by someone who wants your property is really, really unlikely. According to Forbes, this is why "the vast majority of exchanges are delayed, three party, or Starker exchanges (named for the first tax case that allowed them). In a delayed exchange, you need a middleman who holds the cash after you "sell" your property and uses it to "buy" the replacement property for you. This three-party exchange is treated as a swap."

1 – Simultaneous Exchange

This allows investors to relinquish and close on a replacement property in the same day. Originally, this is what a 1031 exchange was–a direct exchange between two parties.

Today, this type of exchange isn't very common. Why? Because what are the chances that the person who owns the exact property you want also wants the exact property you own? It can happen, but the possibility is pretty slim.

2 – Delayed Exchange

The delayed like-kind exchange is by far the most common type of exchange chosen by investors today. This type of exchange gives investors a maximum 180 days after the sale of their property to identify replacement property.

3 – Reverse Exchange

In theory, the reverse 1031 exchange is very simple: you buy first and you pay later. What makes it difficult, however, is that this type of exchange must be an all cash purchase AND most banks won't lend to you. Why is it so difficult to get a loan? It's because you cannot be on title to the replacement and the relinquished property at the same time.

The solution: you can create an LLC that can take title to the replacement property. Once you sell the original property, you can transfer the title of the replacement property into your name.

4 – Construction/Improvement Exchange

There are a lot of investors that sell a property, and realize that the one they want to buy costs less than the one I relinquished.

What do you do? Well, since paying taxes is out of the question…you might consider doing a Construction or Improvement Exchange.

This type of exchange allows you to use the remaining funds to build or improve on the property you want to buy.

What Real Estate 1031 Exchange Rules Must I Follow?

Rule 1: Like-Kind Property

To qualify as a 1031 exchange, the property being sold and the property being acquired must be "like-kind."

Like-Kind Property Definition: Like-Kind property is a very broad term which means that both the original and replacement properties must be of "the same nature or character, even if they differ in grade or quality." (4) In other words, you can't exchange farming equipment for an apartment building, because they're not the same asset. In terms of real estate, you can exchange almost any type of property, as long as it's not personal property.

For example:

1. Exchanging an apartment building for a duplex would be allowed.
2. Exchanging a single-family rental property for a commercial office building would be allowed
3. Exchanging a rental property or vacation rental for a restaurant space would be allowed.

EXCEPTION: It's important to note that the original and replacement property must be within the U.S. to qualify under section 1031.

**Another fun fact: Starker Exchanges can include more than two properties. For example, you can exchange one property for multiple replacement properties and vice versa: you can exchange multiple properties and for one larger property. As long as the new properties are like your original properties, you're good to go. Do yourself a favor and get a good qualified intermediary to assist you.

Rule 2: Investment or Business Property Only

A 1031 exchange is only applicable for Investment or business property, not personal property. In other words, you can't swap one primary residence for another.

For example:

1. If you moved from California to Georgia, you could not exchange your primary residence in California for another primary residence in Georgia.
2. If you were to get married, and move into the home of your partner, you could not exchange your current primary residence for a vacation property.
3. If you were to own a single-family rental property in Idaho, you could exchange it for a commercial rental property in Texas.

Rule 3: Greater or Equal Value

In order to completely avoid paying any taxes upon the sale of your property, the IRS requires the net market value and equity of the property purchased must be the same as, or greater than the property sold. Otherwise, you will not be able to defer 100% of the tax.

For example, let's say you have a property worth $2,000,000, and a mortgage of $500,000. To receive the full benefit of the 1031 exchange, the new property (or properties) you purchase need to have a net worth of at least 2 million dollars, and you'll have to carry over at least a $500,000 mortgage. It's important to note that the $2,000,000+ value, and $500,000 mortgage, can go towards one apartment building or three different properties with a total value of $2,000,000+. (FYI: Acquisition costs, such as inspections and broker fees also apply toward the total cost of the new property.)

Rule 4: Must Not Receive "Boot"

A Taxpayer Must Not Receive "Boot" from an exchange in order for a Section 1031 exchange to be completely tax-free. Any boot received is taxable to the extent of gain

realized on the exchange. In other words, you can carry out a partial 1031 exchange, in which the new property is of lesser value, but this will not be 100% tax free. The difference is called "Boot," which is the amount you will have to pay capital gains taxes on. This option is completely okay, and often used when a seller wants to make some cash, and is willing to pay some taxes to do so.

An example of this would be if your original property is sold for $2,000,000 and the property you wish to exchange under section 1031 is worth $1,500,000, you would need to pay the normal capital gains tax on the $500,000 "boot."

Rule 5: Same Tax Payer

The tax return, and name appearing on the title of the property being sold, must be the same as the tax return and title holder that buys the new property. However, an exception to this rule occurs in the case of a single member limited liability company ("smllc"), which is considered a pass-through to the member. Therefore, the smllc may sell the original property, and that sole member may purchase the new property in their individual name.

For example, the single member of "Sally Jones LLC" is Sally Jones. The LLC can sell the property owned by the LLC, and because Sally Jones is the sole member of the LLC, he can purchase property in his name, and be in compliance with the 1031 code.

Rule 6: 45 Day Identification Window

The property owner has 45 calendar days, post-closing of the first property, to identify up to three potential properties of like-kind. This can be really difficult because the deals still need to make sense from a cash perspective. This is true especially in today's market because people tend to overprice their properties when there are low-interest rates, so finding all the properties you need can be a challenge.

An exception to this is known as the 200% rule. In this situation, you can identify four or more properties as long as the value of those four combined does not exceed 200% of the value of the property sold.

Rule 7: 180 Day Purchase Window

To qualify under a 1031 exchange, it's necessary that the replacement property be received and the exchange completed no later than 180 days after the sale of the exchanged property OR the due date of the income tax return (with extensions) for the tax year in which the relinquished property was sold, <u>whichever is earlier</u>.

As you might realize, there are many rules and qualification requirements that you must comply with in order to perform a successful 1031 exchange. To sum things up, the

biggest advantage of a 1031 exchange is that you can avoid having to pay capital gains taxes on the sale of an investment property. This can be a huge benefit for real estate investors who know which markets are primed to grow next. It can also be a huge downfall for beginning investors, or those who don't understand the changing real estate landscape. If you don't, you risk falling victim to one the biggest disadvantages of a 1031 exchange–the reduced basis for depreciation on the replacement property.

This means that if you were to sell your replacement property, even at a deficit, you would still be accountable for the capital gains on the initial property. In other words, if you want to maximize the benefits of your exchange, it's important that you choose your replacement property (or properties) wisely, investing in a market that has good potential for growth in the future.[i]

IRS REPORTING DEADLINE

You must report a tax-deferred exchange to the Internal Revenue Service using IRS Form 8824 (Like-Kind Exchanges), with your Federal income tax return for the tax year in which you sell the Relinquished Property. You must acquire your Replacement Property before you file this income tax return. Therefore, if you have not acquired your Replacement Property by the filing date for that tax year (March 15 or April 15 for calendar year taxpayers), then you must apply for an extension to file for the tax year in which you sold the Relinquished Property

RELATED PROPERTY EXCHANGES

In most cases you cannot purchase Replacement Property from a "related party" (family member or controlled corporation, partnership or trust) as that term is defined by the Internal Revenue Code.[ii]

INTERNAL REVENUE CODE 1031 OVERVIEW

"No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business for investment if such property is exchanged solely for property of like-kind which is to be held either for productive use in a trade or business or for investment."

Enacted in the tax code of the IRS in 1921

Starker decision of 1979 9th circuit court of appeals set [precedence] for modern exchange rules.[iii]

DISCLAIMER The materials cited above are provided for informational purposes only. It is always recommended that you discuss any plans related to a 1031 Exchange with your CPA and/or attorney.

[i] Real Wealth Network 2018

[ii] texas1031exchange.com

[iii] Champions School of Real Estate