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1031 EXCHANGE

In 1921, the Revenue Act allowed for a new tax deferral strategy for business investors. This exchange is now referred to as a 1031 exchange, in reference to the Internal Revenue Code (IRC) Section 1.1031, which outlines the requirements of the exchange. Through a 1031 exchange, investors can defer capital gains taxes when selling one investment property and purchasing another.

However, while a 1031 exchange sounds simple — sell one investment property and purchase another — there are numerous requirements and strict timelines involved in the process. In order for an investor to take advantage of this tax deferral strategy, it is imperative to understand which property sales and purchases qualify for a 1031 exchange and what methods exist for enacting this type of transaction.

What Is a 1031 Exchange?

A 1031 exchange allows real estate investors to defer capital gains taxes when investing in a new property. Essentially, with a 1031 exchange, an investor will swap one investment property for a new property. Usually, when selling an investment property and purchasing a new one, the sale is taxable. However, if an investor can meet the requirements of IRC section 1031, they can avoid paying taxes or only pay a limited tax at the time of the exchange.

The requirements of a 1031 exchange are as follows:

- During the property swap, the new replacement property must be a like-kind property. It also must be of equal or greater value to the property being sold.
- The property swap must involve two properties with similar uses. For example, an investor cannot swap a storage facility in a 1031 exchange for a personal vacation home.
- The investor cannot hold the money made from the sale of an existing property at any time. It must be held in escrow by a Qualified Intermediary.

Many investors use 1031 exchanges to continue to grow their investments while transitioning from one form of investment to another. Because there is no limit to the number of times an investor can use a 1031 exchange to avoid capital gains taxes, this is a highly useful tool for large portfolios. With a 1031 exchange, an investor can essentially roll their gains from one property into a new investment, putting off the need to pay taxes on those gains until further down the road.

What Is Capital Gains Tax?

To understand the full benefit of a 1031 exchange, it is important to first understand what capital gains tax is. Capital gains tax is essentially a tax that an investor must pay on the profits made from the sale of an investment property. This will be owed for the tax year during which the property was sold. Because the tax rates for capital gains are quite high, there is a significant amount of savings for investors who defer these taxes.

What Is a Like-Kind Exchange?

One of the specific requirements of a 1031 exchange is that the properties exchanged must be like-kind. What exactly is a like-kind exchange? Like-kind is a fairly broad term that essentially means that the asset being sold and the asset being acquired must be a similar form of investment.

In the case of real estate, almost any replacement real estate property will be similar enough to be considered like-kind. For example, selling a condo and purchasing an apartment complex is considered like-kind. Similarly, an investor could sell a storage facility and purchase a multi-family housing unit.

Selling a real estate property and investing in a partnership interest is an example of what would not be like-kind.

Ultimately, because each situation is unique and due to the vagueness of "like-kind," investors should always work with a trusted advisor who can help them determine whether or not an exchange qualifies under Section 1031.

What Are the Types of 1031 Exchanges?

While a 1031 always includes the eventual exchange of two properties, there are multiple methods to accomplish this, each with its own unique pros and cons. The following are the four types of 1031 exchanges.

#1: Delayed Exchange

One of the most common forms of a 1031 exchange is called a delayed exchange. In a delayed exchange, an investor starts by selling their investment property prior to purchasing their replacement property. This makes it possible for an investor to roll the funds over from the sale of the first property into the purchase of the second property.

For a delayed exchange to occur, an investor will need to list their property, secure a buyer, and close on the sale. Once the sale is completed, the funds from the sale must not be in the investor's possession. Instead, a Qualified Intermediary will retain the proceeds of the sale until the seller identifies and purchases a like-kind property.

What Is the Timeline for a 1031 Delayed Exchange?

One of the trickiest parts of qualifying a property exchange as a 1031 exchange is meeting the strict deadlines outlined in the IRC section 1031. Once an investment property is sold, if it is part of a 1031 exchange, the clock starts ticking, and critical deadlines must be met.

The first deadline is to identify a replacement property. The investor must do this within 45 days after the sale of the initial investment property. This is perhaps one of the hardest components to control in a 1031 exchange. It can be difficult to guarantee that a quality investment will arise during such a short period of time. For this reason, it is important for investors to begin scouting for their next investment prior to putting their current property up for sale. Waiting until the sale of the initial property to search for a qualified replacement can be risky.

Once an investor has identified a replacement property — or multiple options (the IRS allows up to three as long as the investor closes on at least one of them) — they must progress quickly forward. From the time of the sale of the initial property, an investor has 180 days total to close on a new property.

It is also important to note that the two time periods of 45 days and 180 days run concurrently. This means that if it takes an investor 40 days to find a replacement property, they are left with 140 days to close on the property.

#2: Simultaneous Exchange

A simultaneous exchange involves selling and acquiring a property on the same exact day. In order for a simultaneous exchange to occur, there cannot be a single delay on either side of the process. This is one of the reasons that simultaneous exchanges are less common. It can be difficult to ensure that a property sale and acquisition will happen at the same time.

There are different ways to handle a simultaneous exchange transaction. In some cases, two investors will swap deeds of properties on their own. However, due to the complications of 1031 exchanges, it is rare for investors to tackle this exchange on their own. In most cases, a simultaneous exchange will occur with the help of a Qualified Intermediary. This is particularly important when there are other stipulations attached to a property swap.

#3: Reverse Exchange

A reverse exchange is the exact opposite of a delayed exchange. In a reverse exchange, an investor purchases a like-kind property before selling their existing property. The key benefit to this type of exchange is that it allows an investor to try to play the real estate market to their advantage. The investor can purchase a property during a

downturn in the market and then sell their property when the market swings back upward.

However, just like a delayed exchange, a reverse exchange is subject to tight timelines. This makes it extremely difficult to pull off as it is hard to guarantee the rapid sale of a property.

Additionally, during a reverse exchange, the investor will need to relinquish the deed to their existing property to a Qualified Intermediary, similar to the funds from the sale in a delayed exchange.

Lastly, one of the trickiest parts of pulling off a reverse exchange is acquiring adequate funding. Unlike a delayed exchange, an investor does not have the benefit of using the funds from their property sale to roll into their next purchase. Instead, they must look for alternative funding.

Working with a lender commercial mortgage broker that can help you understand all of these factors will be critical in determining whether or not a forward rate lock is an ideal solution for your needs.

#4: Improvement Exchange

Finally, the fourth type of 1031 exchange is an improvement exchange. In this exchange, an investor sells their existing property, and the Qualified Intermediary holds the proceeds. What makes this different than a delayed exchange is that the investor can identify a property they wish to purchase that might need improvements. Improvements can be as simple as repairing a property in disarray or as complicated as constructing an entire building.

The investor can use the money from the proceeds both for closing on the new property and for making improvements to the property. However, all of this must still take place during the 180-day timeline.

This is what makes an improvement exchange exceedingly tricky. Ensuring that construction will take place on a strict timeline is a true challenge. And, if the improvements are not completed on time, the eligibility for the 1031 tax deferment can be lost, making it a risky endeavor for investors. However, if it can be pulled off, an improvement exchange can be an extremely powerful method for growing a portfolio and taking advantage of a great deal on a property in need of improvements.

Choosing a Qualified Intermediary

For investors interested in taking advantage of a 1031 exchange, it is imperative to find a Qualified Intermediary. This exchange facilitator should be well-versed in the incredible complexities and nuances of 1031 requirements. 1031 exchanges are rarely simple swaps between two parties. Most of the time, they require the involvement of a vast number of parties, including buyers, sellers, real estate agents, mortgage lenders, and more.

For this reason, working with a well-established Qualified Intermediary is a must. This individual will also be responsible for holding onto the sale proceeds and disbursing funds through an escrow account. While all real estate transactions are time sensitive, 1031 exchanges are particularly vulnerable to delays. A simple delay in paperwork could jeopardize the entire process.

Additionally, investors should speak to their tax advisor and financial planner about any proposed 1031 exchange. These professionals can help highlight the potential pitfalls in the process and can ensure that the best tax breaks possible are gained from the process.

To learn more about the potential benefits of a 1031 exchange for your investment portfolio, feel free to reach out to our team at Slatt Capital. We will be happy to help walk you through the advantages you could earn by deferring capital gains taxes and work with you to ensure that you have your financing in order.