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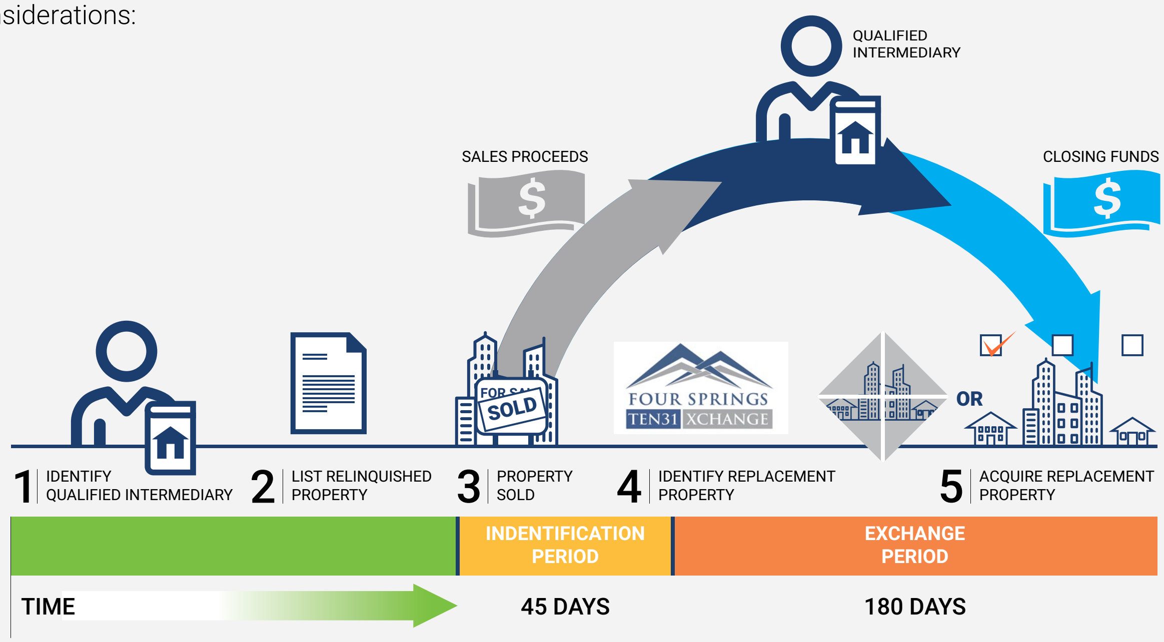
How to Successfully Defer Taxes in a 1031 Exchange

What is a 1031 Exchange?

In the simplest terms, a 1031 exchange is a tax deferred swap of one asset for another of like-kind. Though not exclusive to real estate, it is widely used by property investors, and net lease properties have become popular replacement properties for investors due to the long-term nature of the leases, the durability of the rental income and the limited management responsibilities.

However, despite their prevalence, 1031 exchanges can be complex and remain confusing to many investors.

In order to navigate the process and achieve 1031 success, investors should be mindful of the following considerations:



The Exchange Must Be "Like-Kind"

With real estate, the Internal Revenue Code guidance on "like-kind" properties is broad and most real estate will qualify for an exchange. For example, vacant land may be exchanged for commercial real estate or a residential rental property. While it is most common for an investor to reinvest their proceeds into a single asset, the code also allows for a swap into multiple properties. In this way investors can more easily match sale proceeds with their re-investment opportunities.

However, the IRS does specify a few primary restrictions, namely properties located outside the United States, primary residences, and improvements not conveyed with land do not qualify as like-kind real estate.

Exchanges are Time Sensitive

Although the term “swap” is used to describe 1031s, most transactions feature a delayed exchange and involve the sale of one investment property followed by the subsequent purchase of another. In order to qualify for the tax deferral, investors must meet the following deadlines:

Identification Period (45 Days)

After sale of the original investment, investors have 45 days to identify the replacement properties. The identification must be in writing, signed, and delivered to a person involved in the exchange such as the seller or a qualified intermediary.

Closing Period (180 days)

Following the original sale, the investor has 180 days to complete the purchase of one or more of the replacement properties that were named in the identification period. However, this time limit is overridden if the tax returns for original investment sale are due (including any extensions) prior to the 180th day.

No Receipt of Cash

Investors are prohibited from taking control of cash from the original investment sale. If the proceeds pass directly to the investor prior to the purchase of the replacement property, the exchange may be disqualified and the gains made taxable. Note, however, that an investor may receive cash or other property that is not considered like-kind property (often referred to as “boot”) as part of the exchange, and the exchange will still qualify for tax deferral under Section 1031. In those cases, the investor is taxed only to the extent of the boot that they receive.

To avoid this, investors commonly use an exchange facilitator or qualified intermediary to hold sale proceeds until the exchange is completed. It is important to remember that this agent cannot be you or your real estate agent, broker, accountant, attorney, or anyone who has worked for you in these capacities during the prior two years.

Final Thoughts

In a 1031 transaction the capital gains taxes are deferred, not eliminated. It is important to note that when the replacement property is ultimately sold the original deferred gain and any additional gains on the replacement property will be subject to tax. The exception being if the replacement property is sold as part of another 1031 exchange. Taxpayers must report an exchange to the IRS on Form 8824, Like-Kind Exchanges and file it with their tax return for the year in which the exchange occurred. While 1031 exchanges require careful planning and close oversight, they are a powerful tool to preserve an investor’s purchasing power.

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