Intro to 1031 Exchanges

Compound Your Wealth with 1031s

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WHAT'S A 1031 EXCHANGE?

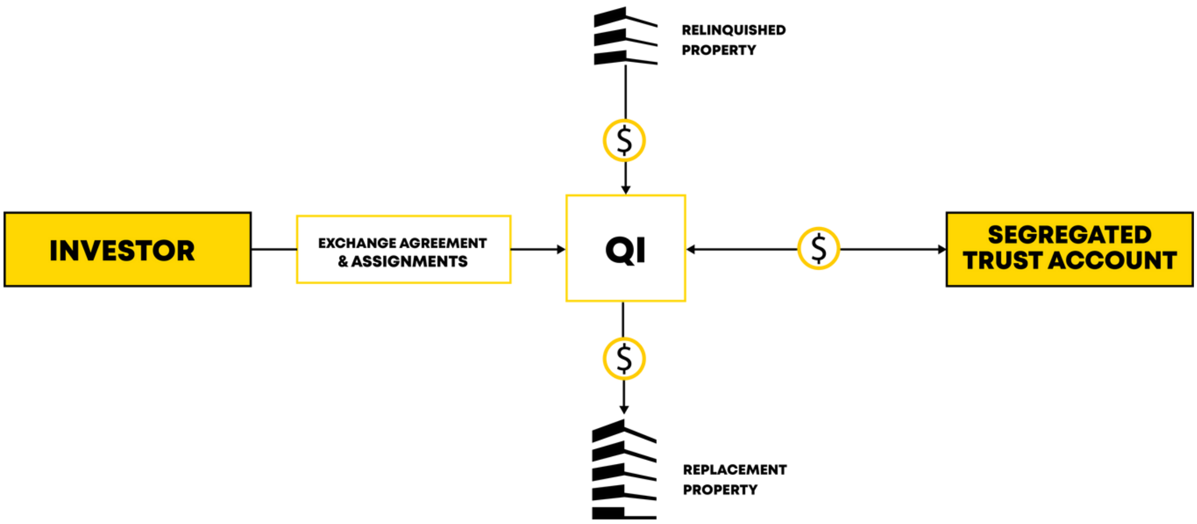
For more than 100 years, the tax laws of the United States have allowed investors to defer taxes on the gains generated by the sale of an investment property if the proceeds are properly re-invested in "like-kind" property.

This form of tax deferral is governed by Section 1031 of the Internal Revenue Code. It says: "No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment, if such property is exchanged solely for property of like-kind [...]".

Simply put, a 1031 exchange is the swap of one investment property for another like-kind property without paying tax. A 1031 exchange transaction happens just like any normal real estate transaction, with two key differences:

1. You must hire an independent 3rd party known as a Qualified Intermediary to facilitate your 1031 exchange.

2. You may not take constructive receipt of your funds.



This graphic shows you the mechanics of a 1031 transaction. First, you will sign an agreement with a Qualified Intermediary (QI). When your relinquished property is sold, your QI will direct your proceeds to its partner bank. When it's time to close on your replacement property, your QI will direct your funds from the bank to the seller of the replacement property, completing your 1031 exchange.

DON'T SELL... EXCHANGE!

Why would you explore a 1031 exchange? The better question is, why wouldn't you?

1031 exchanges offer you the ability to defer – and even eliminate – your real estate taxes and maximize your real estate gains. They are a cheat code to building wealth.

It's not just federal taxes that can be deferred – state taxes, investment income taxes, alternative minimum taxes, and depreciation recapture taxes may also be deferred. It's like an interest-free loan from the US Government – one that may never require repayment.

The true power of a 1031 exchange is the ability to meet your investment objectives without losing equity to taxation. With more money, you can buy more property. Consider a scenario where you have $500,000 in equity in an investment property you are selling. The financial benefit of a 1031 exchange is enormous, allowing you to reinvest $325,000 more into your next property!

	EXCHANGE	NO EXCHANGE	DIFFERENCE
Equity	$500,000	$500,000	
Capital Gain Tax	$0	$65,000	
Equity to Reinvest	$500,000	$435,000	
Acquisition Value (Assume 20% Down)	$2,500,000	$2,175,000	$325,000

THE MAGIC OF 1031 EXCHANGES

As the previous page shows, the financial benefit of a single 1031 exchange is enormous. Now let's look at what happens if you do multiple 1031 exchanges during your lifetime.

50% GAIN EACH TRANSACTION	1031s, COMPOUDING TAX FREE	NO 1031S, TAXED AT 30% EACH TIME
Starting Equity	$100,000	$100,000
Transaction 1	$150,000	$135,000
Transaction 2	$225,000	$182,500
Transaction 3	$337,500	$246,038
Transaction 4	$506,250	$332,151
Transaction 5	$759,375	$448,403
Transaction 6	$1,139,063	$605,345
Transaction 7	$1,708,594	$817,215
Transaction 8	$2,562,891	$1,103,240
Transaction 9	$3,844,336	$1,489,375
Transaction 10	$5,766,504	$2,010,656
Transaction 11	$8,649,756	$2,714,385
Transaction 12	$12,974,634	$3,664,420
Transaction 13	$19,461,951	$4,946,967
Transaction 14	$29,192,926	$6,678,405
Transaction 15	$43,789,389	$9,015,847
Transaction 16	$65,684,084	$12,171,393
Transaction 17	$98,526,125	$16,431,381
Transaction 18	$147,789,188	$22,182,684
Transaction 19	$221,683,782	$29,946,192
Transaction 20	**$332,525,673**	**$40,427,359**

This table demonstrates the impact of taxes on compounding. The same transactions, the same returns each time. The only difference between the middle column and the right column is deciding to 1031 versus not. At the end, 1031s net you $292 million more. This is the power of tax-free compounding. This is the magic of 1031s.

5 COMMANDMENTS OF 1031 EXCHANGES

To master the 1031 exchange code, you must know the rules. 90% of what you need to know can be distilled into these 5 Commandments:

Commandment 1

The property must be held for business or investment purposes.

Commandment 2

To defer all tax, you must purchase a property of equal or greater value than the net selling price of your relinquished property.

Commandment 3

Within 45 days following the close of your first transaction, you must identify, in writing, up to three possible replacement properties (you can identify more than three, but there are additional rules if you do). Only identified properties qualify for the exchange.

Commandment 4

You have 180 days to complete both sides of your exchange (the buy and sell). This deadline is firm, regardless of whether the 180th day falls on a Saturday, Sunday or Holiday.

Commandment 5

You must use a Qualified Intermediary to facilitate your 1031 exchange.

6 THINGS YOU DIDN'T KNOW ABOUT 1031s

Want to be smarter than 99% of your peers when it comes to 1031 exchanges? Here's a short list that'll get you there:

#1 : It's a Large Market With A Long History

1031 exchanges account for an estimated 15% of all US commercial real estate transactions annually. That's $185 billion worth of 1031 exchanges per year!

Not only is it a huge market, but it's more than a century old. The 1031 exchange rules were created in 1921 following World War I.

#2: There Are 4 Types Of 1031 Exchanges

There are 4 primary types of 1031 exchanges:

1. **Forward Exchange:** In a Forward Exchange, an investor sells a property first, then buys within 180 days.

2. **Reverse Exchange:** In a Reverse, an investor buys first, then sells within 180 days.

3. **Simultaneous Exchange:** A simultaneous buy-sell. These types of exchanges aren't very common today.

4. **Improvement Exchange – Forward or Reverse:** In an Improvement Exchange, an investor invests in the acquired property – which can include repairs, improvements and / or new construction – using exchange equity. Improvement 1031 Exchanges are used in conjunction with either a Forward Exchange or a Reverse Exchange structure.

#3: You Can Do An Unlimited Number Of 1031 Exchanges

There is no limit to the number of times you can do 1031 exchanges. Many 1031 grandmasters just keep exchanging. Why? Because if you keep rolling one 1031 exchange into another until your time on Earth is up, you will not only have deferred taxes on your gains each time, but you will have accomplished the seemingly impossible: avoiding taxes altogether. How is this? Because when your properties pass to your kin, they get a step-up in basis, effectively making a lifetime worth of gains invisible to the US Government.

This is known as the “swap ‘till you drop” strategy.

#4: There Are Nearly Infinite Exchange Options

You can exchange raw land for a rental home, an apartment complex for a shopping center or rental houses for an office building – there are more than 16 types of real estate that qualify for 1031 exchanges. And you can exchange any of these types of property inside any of the 384 Metropolitan Statistical Areas in the US. So long as all property is held for business or investment purposes, you have nearly infinite exchange options.

#5: You Don’t Need To Tell Anyone But Us

There is no provision in the 1031 rule book that states you have to publicly disclose that you're doing a 1031 exchange. You don't need to tell anyone you're exchanging other than your QI and your tax advisors. And you certainly don't have to advertise yourself as a 1031 buyer.

#6: Proper Planning Prevents Poor Performance

There are many ways to prepare for a 1031 exchange before the 45-day identification clock starts ticking. You can put your replacement property under contract first. You can enter into an option contract to buy your replacement property. Or you can have your broker create a shortlist of target replacement properties for you. Proper planning can minimize and even eliminate the time pressure of a 1031 exchange.

FAQs

When should I reach out to 1031 Specialists about my exchange?

Ideally, you will engage us during the evaluation stage of your first transaction, just prior to signing your Purchase & Sale agreement. If you've already signed your PSA, no worries – we can still help make your 1031 exchange happen.

Can I sign a Purchase & Sale Agreement, then start exploring a 1031 exchange?

Yes. The date a PSA is signed – for either your relinquished property or replacement property – isn't relevant to your 1031 eligibility. What matters is the date your first transaction closes. Provided you haven't closed, you still have time to explore a 1031 exchange.

If I want to identify more than three replacement properties during my 45-day identification period, what are the additional requirements I must follow?

If you wish to identify more than three replacement properties, you can. However, identifying four or more properties means your exchange must also pass one of these two additional tests:

1. The 200% Rule: the combined fair market value of all your identified replacement properties cannot exceed 200% of the value of your relinquished property.
2. The 95% Rule: you can exceed the 200% rule but you must acquire >=95% of the fair market value of the properties you identify.

If I hold a property in a corporate entity, can I still qualify for a 1031 exchange?

Yes. Any taxpayer, whether an individual, married couple or entity, can successfully complete a 1031 exchange. Qualifying entities include C-Corporations, S-Corporations, General Partnerships, Limited Partnerships, Limited Liability Companies, Trusts, and any other taxpaying entity that owns qualifying property.

What happens if I don't complete my 1031 exchange in time?

If you don't meet the key 45 and 180-day deadlines required by the IRS, your exchange fails and you will be taxed on any gains from the sale of your property. You can still buy and sell property, you just won't get the benefit of tax deferral on the transaction. It'll be like your 1031 exchange never existed.

Will a 1031 exchange put me at risk of an IRS audit?

1031 tax-deferred exchanges are a 100% approved method of buying and selling investment property – these rules have existed in the US for more than 100 years. In our experience, as long as a recognized, qualified firm follows U.S. Tax Code, Title 26, Section 1031, and documents everything properly, there is no additional risk of an audit.

When do I report the exchange to the IRS?

Exchanges are reported to the IRS for the tax year in which the first relinquished property is transferred, even if the replacement property(ies) are transferred in the following tax year. For example, if you close on your relinquished property in December and settle on your replacement property in May of the following year, you will file an extension by mid-April and then file IRS Form 8824 once your replacement property is received.

If I did a cost segregation study and benefitted from bonus depreciation on the property I'm selling, can I still do a 1031 exchange?

Yes, you can do both a 1031 exchange and cost segregation / bonus depreciation on the same property. It is imperative that you seek tax counsel to understand the tax implications given your unique circumstances.

Does my Airbnb property qualify for a 1031 exchange?

Yes, subject to certain criteria, short-term rentals qualify under 1031 tax-deferred exchange rules.

How do I maximize my tax deferral in a 1031 exchange?

To maximize your tax deferral, you will have to purchase property of equal or greater value than the net selling price of your relinquished property. You will also have to reinvest the full amount of cash received from the sale of your relinquished property. If you do these two things – buy a replacement property of equal or greater value and reinvest all your cash proceeds – you will maximize your 1031 tax deferral.

Does the replacement property have to cost more than the relinquished property?

No. You can purchase a replacement property for less than your relinquished property and still receive some 1031 tax benefits. If you seek full tax deferral, you will have to purchase property of equal or greater value than the net selling price of your relinquished property.

What is the role of a Qualified Intermediary?

A Qualified Intermediary has three primary duties:

1. To provide consultation on your 1031 exchange.

2. To secure your funds during the duration of the exchange.

3. To prepare the necessary exchange documentation and coordinate with your closing agents to properly transfer the relinquished and replacement properties according to U.S. Treasury Reg. §1.1031(k)-1(g)(4).

Can I be my own Qualified Intermediary?

No, your Qualified Intermediary must be an independent third party, not a related party or agent. CPAs, attorneys, investment bankers, and real estate agents / brokers generally fall under the 'agent' category, excluding them from acting as your Qualified Intermediary. Additionally, any business or individual who is affiliated with an agent also cannot act as your Qualified Intermediary.

When do I need to hire a Qualified Intermediary?

If you do not have a Qualified Intermediary in place before the close of your first transaction, the opportunity to do a 1031 exchange is lost.

Why does a Qualified Intermediary control my sale proceeds?

A key requirement of a successful 1031 exchange is that the investor selling the property must avoid constructive receipt of the proceeds from the sale. If you have the ability to access, control or receive, or could have received, the proceeds from your sale, the IRS will disqualify your 1031 exchange.

DEFER YOUR REAL ESTATE TAXES.

MAXIMIZE YOUR REAL ESTATE GAINS.

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Have questions on a specific transaction?

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Every 1031 exchange is unique. This information provides an overview of 1031 exchange requirements. You should always discuss your situation with a tax and/or legal advisor.