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The 1031 Exchange Explained

In the world of real estate, the Section 1031 exchange has been a significant tool for investors who want to grow their real estate portfolio and wealth. A 1031 exchange enables a property owner to defer capital gains taxes on the sale of a property by investing the sale proceeds in new property. By deferring the taxes, property owners have additional funds to invest in new property and are thus able to accelerate the growth of their portfolio. However, a 1031 exchange also has several parameters, rules and deadlines that need to be followed throughout the transaction's process to qualify for the tax benefits. In this Document, we'll explain how a 1031 exchange works and important considerations when using one.

A 1031 exchange takes its name from Section 1031 of the U.S. Internal Revenue Code which permits property owners to defer paying federal capital gains taxes after selling one investment property and purchasing another property within a certain amount of time.

When seeking a 1031 exchange, the IRS requires that the exchange be between like-kind properties, i.e., the two assets must be similar. In practice, an investor can trade vacant land for a commercial building, or an industrial property can be exchanged for a retail property. However, you cannot swap real estate for artwork because that does not meet the like-kind requirement.

There are no limits to how many 1031 exchanges you can do and no cap to the amount of capital gain tax you can defer. However, you must roll all of the proceeds from a sale into new like-kind property in order to maximize the tax deferral.

Tax deferral is a substantial upside to a 1031 exchange, but it doesn't come without some rules.

Unless a taxpayer is going to sell a property and purchase new property at the same time, the sale proceeds will need to be held by a qualified third-party intermediary. If the taxpayer receives the sale proceeds directly, it will violate the 1031 exchange rules.

The taxpayer has 45 days from the date of sale to designate replacement property they intend to purchase. The taxpayer can designate up to three different properties, and in certain circumstances more than three. But, the taxpayer must only close on one property.

The taxpayer has 180 days from the date of sale to close on the acquisition of the replacement property. It's important to note that it's 180 days from the property sale and not 180 days from the designating the replacement property.

A common challenge for transactions that use 1031 exchanges is when a buyer transfers to a property or properties that in aggregate cost less than the property they sold. In these situations, the taxpayer is responsible for paying capital gains tax on the difference between the property they sold and the property they purchased.

For example, if the taxpayer sells a property for $500,000 and subsequently purchases an asset for $450,000, they are liable for the capital gains tax on the $50,000 difference between the two. This is commonly known as "boot" in a 1031 exchange.

Fortunately, boot can be avoided and minimized in several ways. Aside from simply trading up for a higher-priced property, taxpayers can reinvest the excess funds into the new property by spending on personal property, renovations or maintenance related to the new property.

Deferring capital gains tax is an attractive option for people who are looking to move or make a change in their vacation homes, but you must be aware of several things.

The first is personal homes do not qualify for 1031 exchanges. However, the profits from selling your principal residence are tax-free as long as the increase in value from one home to the next one is less than $250,000 for individuals or $500,000 for married couples.

Applying a 1031 exchange to a vacation home or second residence is more challenging and requires advanced planning.

To qualify as a relinquished property, the home must have been owned for at least 24 months immediately before the exchange, and during each of those two years, it must have been rented out at market rates for fourteen or more days and not used personally for the greater of fourteen days or 10% of the number of days it was rented out.

For the replacement property to qualify, the home must be owned for at least two years and for each of those two years, it must be rented out at market rates for fourteen or more days and not used personally for the greater of fourteen days or 10% of the number of days it was rented out.

If you are planning to sell a property and want to invest the proceeds into a new property, then a 1031 exchange may allow you to defer federal taxes on capital gains from the sale of the property. However, you will probably need the guidance of your attorney and accountant to ensure the transaction adheres to all IRS rules - even a small error could mean an unwelcome surprise on April 15th.

Final Thoughts

The purpose of this video is to provide a brief overview of a Section 1031 exchange and is not a replacement for discussing it with one of our experts.

If you are considering a 1031 exchange and want to discuss your unique situation, please contact our office. Our expert advisors are happy to help.

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About Horty & Horty.

Horty & Horty, P.A. ("Horty") is a full-service public accounting and advisory firm providing personalized and unparalleled service to closely held businesses and owners throughout the Delaware Valley. We are trusted advisors whose service offerings and proven methodologies are designed to mitigate financial risk and help clients realize their goals and achieve success.

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