



Simplifying a 1031 Exchange





What is a 1031 Exchange?

A 1031 exchange is a tax rule that allows investors to defer capital gains taxes when selling a property and reinvesting the proceeds into a “similar” property.

Defers not only federal taxes, but also state taxes, AMT, and depreciation recapture

Investors must follow several IRS guidelines in order to defer most/all taxes associated with the sale



Four options when selling commercial real estate:

1. Pay any capital gains taxes and depreciation recapture, and the remaining proceeds may be spent or reinvested.
2. Utilize a 1031 Exchange by purchasing conventional commercial real estate as the replacement property, deferring any taxes on the appreciated property.
3. Utilize a 1031 Exchange by purchasing Delaware Statutory Trusts (DST's) as the replacement property, deferring any taxes on the appreciated property.
4. Combine options #2 and #3



What is the benefit of deferring taxes on real estate gains via 1031 exchange?

In a properly executed 1031 exchange, with the taxes deferred, more investment dollars are available for the new investment property.

With more dollars available for re-investment, there is far more wealth accumulation before taxes are owed.

1031 exchanges can occur over and over, with the compounding effect of tax-deferred growth having an increasingly significant effect over time.



A comparison: paying vs. deferring taxes

	Scenario A Paying Taxes on Property Sale	Scenario B Completing a 1031 Exchange
Purchase Price	\$300,00	\$300,00
Capital Improvements	\$50,000	\$50,000
Depreciation	\$150,000	\$150,000
Adjusted Cost Basis	\$200,000	\$200,000
Sale Price cost of Sales	\$440,000	\$440,000
Total Taxable Gain	\$240,000	\$240,000
Long Term Capital Gain Liability (20%)	\$48,000	\$0
State Tax (Q-13.3%)	\$0 - \$31,920	\$0
Net Investment Income Tax (3.8%)	\$9,120	\$0
Depreciation Recapture Tax (25%)	\$37,500	\$0
Total Taxes Due	\$94,620 - \$126,540	\$0
Net Proceeds for Investment	\$345,380 - \$313,460	\$440,000



What are the steps in a 1031 exchange?

DAY 0 The investor sells relinquished property to a third party buyer. Identification period begins, sales proceeds are held by Qualified Intermediary (QI)

The investor identifies (documents) possible replacement properties with the QI

DAY 45 Identification period ends.

The QI uses the proceeds to purchase the replacement property on behalf of the investor.

DAY 180 The investor must close on the replacement property no later than 180 days after selling.



What type of properties qualify as a replacement?

Replacement properties can be any of the following:

- Rental Home(s)
- Apartment building
- Condominium
- Shopping Center
- Office Building
- Raw ground, farms, ranches
- Water/air/mineral rights
- Leases of >30 years, such as cell tower leases



Replacement Property identification rules:

1. Three Property Rule: the rule most often uses, allows identifying up to three properties regardless of their value.
2. 200% Rule: may identify any number of replacement properties, as long as their combined value is not more than 200% of the relinquished property
3. 95% Rule: may identify any number of properties regardless of value, but must close on 95% of those properties. Rarely used.



Whatever you need regarding commercial real estate, I can help!

We'll help with your:

- 1031 Exchange
- Equity Raise
- Tax reduction/tax credits
- Non-traditional borrowing
- On/off market CRE
- Joint Venture partnerships

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

