All About 1031 Exchanges

REXCO 1031
REAL ESTATE EXCHANGE COMPANY

What is a 1031 exchange?

Section 1031 of the IRS Tax code allows you to sell an appreciated real estate asset, purchase one of equal or higher value, then defer paying income taxes to a future moment in time. In addition, if you hold the property until death, your heirs would acquire the asset and the value would be "stepped up" to its current fair market value at time of death, and no federal tax would be due.

From the JK Lasser's "Your Income Tax 2020": "You may exchange investment or business real property for "like-kind" property without incurring a tax in the year of exchange. Gain may be taxed upon a later disposition of the replacement property because the basis of the replacement property is usually the same as the basis of the property surrendered in the exchange.

Where property received in a tax-free exchange is held until death, the unrecognized gain escapes income tax forever because basis of the property in the hands of an heir is generally the value of the property at the date of death."

Why does the federal government allow tax deferred exchanges?

The rationale for the 1031 exchange comes from the idea that when an investor "reinvests" capital into a replacement property, it is considered simply a continuation of the original investment. Because all proceeds are reinvested, it would not be considered fair to ask the taxpayer to pay taxes with cash proceeds that they have not received.

Does California recognize allow 1031 exchanges?

Yes, the state of California recognizes 1031s and allow the deferral of income taxes on gains from properly executed 1031s. However, California has a special reporting requirement on taxpayers who do Section 1031 exchanges and acquire out-of-state replacement property. California requires you to file an annual information return (Form 3840) every year until the deferred gain from the Section 1031 exchange is ultimately recognized. Upon sale, the owner must pay California Income Taxes as earned income, as there is no "capital gains" rate for California residents.

What does "like kind" mean?

The "like kind" rule means that you must "trade real property held for business use of investment for like-kind businesses or investment real property". This definition means you can sell any type of real property for any other type as long as the property is a "business asset". So you can sell apartments and buy shopping centers. You can sell farm land and buy a single tenant net leased building. You can sell a rental SFR and combine funds with others to buy a partial interest in a trust that owns multiple rental properties. You have lots of options and the most common ones are discussed below.

Can I use the 1031 solution to sell my primary residence and defer those gains?

The tax code does not allow an owner to sell a primary or second home and take advantage of the 1031 rules since the property is not considered "property held for business use." However, there are ways that you can "convert" your primary residence into a "property held for business use" and take advantage of a 1031. Ask us how to do this.

I've heard the term "Starker Exchange". What does that mean?

The tax deferral 1031 provision in the tax code is nearly 100 years old, created in the Revenue Act of 1921. In the early years of the code, 1031 exchanges were required to be simultaneous closes – meaning the sale of the asset must occur on the same day as the new purchase. In 1979, a taxpayer name T.J. Starker sold timberland to a investment company and allowed the property to transfer over a five year period. Initially the tax court did not allow this non-simultaneous transfer, and demanded that Mr. Starker pay capital gains tax. Starker sued the IRS, won the case, and now the "deferred" exchange is sometimes referred to as a "Starker" Exchange. A "deferred" exchange is simply an exchange that does not happen at the same time as the sale of your property.

Are there any timing requirements that determine when I must purchase the next property?

As a result of the Starker lawsuit, congress placed timing restrictions on like-kind exchanges. In order to comply with the IRS guidelines and preserve the tax deferral benefit, a buyer must identify the purchasing property within 45 days of sale of the relinquished property and must complete the exchange within 180 days.

Are there any restrictions involved in the 45 day identification period?

First, you must identify the replacement property in a written document signed by the seller and delivered before the end of the 45 day period to the entity handling the transfer. You may identify more than one property as replacement property. However, the maximum number of replacement properties without regard to the fair market value is three. You may identify any number of replacement properties provided the fair market value does not exceed 200% of the aggregate fair market value of all the relinquished properties as of the date you transferred them. There are other more complicated options, but keep in mind that if you violate this rule, "you are generally treated as if no replacement property has been identified." (Lasser)

Do I have to purchase a property totally by myself in order to qualify for a 1031 exchange?

No. In 2002, Revenue Procedure 2002-22 was passed which provided investors with an additional replacement property option that did not previously exist. This ruling permitted Delaware Statutory Trusts (DSTs) to qualify as direct ownership of real estate, and therefore as a replacement property solution for 1031 exchange transactions. DSTs as discussed below, allow investors to pool their funds and buy larger properties together with other investors. In addition, tenant-in-common (TIC) structures allow unrelated parties to purchase a "property for business use" and take advantage of the 1031 structure.

Can I trade my property held as a partnership, LLC or corporation and then receive the benefits of a tax free exchange?

First, in general, the entity currently owning the property to be relinquished (sold) must be the same exact entity that buys the replacement/up leg (new) property - transfers are not allowed. Furthermore, partnership interests are not generally permitted within the tax-free exchange. This can be very complicated. Be sure to ask your CPA about 1031s and entity ownership.

I have heard the term "Qualified Intermediary" or QI. What role do Qis play in the 1031 space?

One of the IRS requirements for a successful and allowable 1031 delayed exchanges is that the property title is held temporarily by an independent third party, called a Qualified Intermediary. The QI must also take possession of all sales proceeds at closing and hold those funds until the purchase transaction is completed. Without a QI involved, your 1031 may not be subject to tax deferral. REXCO1031 is not a qualified intermediary, but we will introduce you to a selection of strong and well qualified QIs.

What happens if I receive some money or personal property from the sale of the asset and not all of the cash is invested into the new one?

"If, in addition to the like-kind property, you receive cash or other property (unlike kind such as personal property), the gain is taxable up to the amount of the cash and the fair market value of any unlike property received. The additional cash or unlike property is called 'boot'."(Lasser Tax Guide)

IRC Section 1031 is a complex tax concept: You should consult a legal or tax professional regarding the specifics of your situation. This material is not to be construed as tax or legal advice.