Five critical things to remember when deciding to do a 1031 exchange - by Dwight Kay

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If you've picked up a financial publication recently, chances are you've seen references to 1031 exchanges. A 1031 exchange is a legal way for investors to defer their capital gains taxes on the sale of real estate held for investment or business purposes. It allows one to defer taxes on a property sale as long as they follow specific 1031 rules and guidelines. In other words, you have the potential to keep all your profits working for you with the purchase of your next investment property, without the IRS coming after you looking for their share of the pie. Here are five things to remember before a 1031 exchange.

1. Taxes are Applicable in a Non-1031 Exchange

When an investor sells a property that has gone up in value this results in several types of taxes.

These include capital gains taxes, which the investor must pay if they sell the asset at a price higher than they initially paid for it. Federal capital gains are taxed at 15-20% of the increase in value, while state capital gains are taxed between 0-13.3% of the increase in value.

Depreciation recapture taxes are taxes due when the seller has claimed depreciation expenses on the sold property. Depreciation recapture is currently taxed at 25% of the amount you have depreciated over the years. Other taxes incurred on property sales include the 3.8% Medicare surtax.

The beauty of a 1031 exchange is that you can defer all of these taxes. But if you choose to sell your property without a 1031 exchange, ensure you consult a reputable attorney and CPA so you can know what your full tax bill will be when adding up federal capital gains, state capital gains, depreciation recapture and the Medicare surtax.

2. You Need a Qualified Intermediary

A 1031 exchange isn’t as simple as selling and reinvesting in another property. You must first transfer the relinquished property to an intermediary or an accommodator so they can execute the sale on your behalf. This is a process whereby your sale contract is assigned to the qualified intermediary and when the property closes your funds are then wired to your account at the qualified intermediary. From there you will instruct which properties you would like the qualified intermediary to purchase on your behalf. Kay Properties is not a qualified intermediary however we work with many throughout the country so if you would like a referral please let us know.

3. You Can Only Purchase a Like-Kind Asset

For you to defer taxes via a 1031 exchange, you must reinvest the profits from the sale in like-kind property. In other words, if you sell a property held for investment or business purposes in a 1031 exchange, the replacement property must be of the same character. For example, you could sell an apartment building and purchase a commercial building or you could sell a rental home and purchase a DST 1031 investment.

4. Remember Deadlines

1031 exchanges are subject to strict deadlines. If you sell a property today, you’re expected to have identified the replacement property within the next 45 days and reinvested the proceeds within 180 days. But if you’d already identified the replacement property, you can reinvest immediately.

5. Understand Your 1031 Exchange Options

Once investors have decided to do a 1031 exchange they should consider their options.

First, they could purchase another type of investment property that they would manage on their own.

Second, they could purchase a triple net lease property whereby a national tenant such as Walgreens or FedEx has leased the property for typically 10-15 years. The problem with the triple net leased properties is that it causes investors to place a large portion of their net worth into a single property which could be disastrous (think Blockbuster Video).

Third, if the investor is wanting to get out of active management and the day-to-day issues of dealing with tenants, toilets and trash as well as they are wanting to diversify their investments into multiple properties then a DST 1031 exchange may be a solution. The DST (or Delaware Statutory Trust) is a type of property whereby the management is handled by a third party trustee and since the typical minimum investment of a 1031 DST offering is $100,000 investors are able to purchase a diversified portfolio of Delaware Statutory Trust properties that may include a piece of Walgreens for $100,000, piece of a FedEx distribution warehouse for $100,000 and a piece of a 800-unit portfolio of multifamily properties located throughout the southeast and Texas*.

If you are interested in learning more about your 1031 exchange options please get in touch with us today to learn more.

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