1031 Exchanges Preserve Equity and Build Wealth

The year 2021 marked the 100th year tax-deferred exchanges have been part of the tax code. While the rules have evolved during the last century, exchanges continue to deliver on their intended purpose – encourage reinvestment, stimulate the economy, and create jobs. A 1031 exchange is a strategy to defer gain and depreciation recapture when selling business use or investment real property and reinvesting in another. It is allowed under Section 1031 of the Internal Revenue Code. Also known as like-kind exchanges, they allow real estate investors to grow their real estate portfolio with pre-tax dollars and keep that money invested in real estate and appreciating. Exchanges allow you to acquire replacement property that will generate greater flow, diversify the property type or location, consolidate several properties into one or reduce your management responsibilities.

Under Section 1031, a taxpayer demonstrates the continuity of ownership in like-kind real property with no intervening receipt of cash. At the conclusion of a 1031 exchange, the investor is in the same tax position as if the relinquished property was never sold. Section 1031 accurately reflects the economic reality of every exchange. Investors can always purchase a higher priced property but if they buy for less or reinvest less equity, they must pay tax on the difference. An investor can exchange more than once but if they eventually sell without completing another 1031 exchange, the tax on the deferred gain will be due.

To keep the planning process easy, following is a quick review of the most important rules:

- All properties must be “like-kind” but that refers to the character or use of the property not the specific type of property. Any kind of real property can be “mixed and matched” provided the relinquished and replacement properties are held for use in a trade or business or for investment. True vacation homes and properties being flipped will not qualify for 1031 treatment.
- Beginning on the day you convey title of your relinquished property to a buyer, you will have 45 days to identify replacement property and running concurrently 180 calendar days to acquire your replacement property. In strong real estate markets like we have now, start looking for your replacement property while your old property is still on the market. This will help you maximize your 45-Day Identification Period which will go very quickly. You cannot change your identification after this date.
- Your exchange must be initiated before you close on the relinquished property. An exchange cannot be initiated after closing has occurred.
- To maximize your tax deferral, you must acquire replacement property equal or greater in value than your old property and you must reinvest all net equity. A trade down in value or equity is taxable and is called “boot.”
- You must use a Qualified Intermediary (QI) to facilitate your exchange. Your QI will walk you through each step of the exchange, prepare all necessary documents, coordinate the details with your closing agents, keep you aware of your time deadlines and hold your sales proceeds until you are ready to acquire the replacement property.
- You cannot have control of the exchange proceeds from the sale of the relinquished property during the exchange period. Earnest money deposits can be paid out of your exchange account.
- Your QI must be an independent party and cannot provide tax and/or legal advice. You should always discuss your particular transaction with a tax and/or legal advisor.

Whenever considering the sale of a business or investment, be sure to consider if a 1031 exchange can help you accomplish your investment goals. This hundred-year-old tax strategy can help you build wealth and preserve your equity.