

## Using Tax-Deferred Dollars for a Better Shore Investment Property

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It is no secret the real estate market is red hot, and that is especially true in any resort area. The ability to work remotely has increased the demand for rental properties in resort communities. If you must work, the ability to work from Wilmington and hit the beach at 5 pm is very appealing.

Many of the owners of those highly desired rental properties are considering trading up. Unfortunately, when looking at the property's appreciation, especially over the last few years, and considering the capital gain taxes and depreciation recapture due on the sale, the idea of selling is often dismissed. However, real estate investors who know about 1031 exchanges are seizing the opportunity to trade up while the interest rates remain historically low. These astute investors are moving closer to the water and increasing the number of bedrooms to collect higher rents and build wealth.

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. Exchanges have been allowed since 1921.

Under Section 1031, a taxpayer demonstrates a continuity of ownership in like-kind real property with no intervening receipt of cash. After a 1031 exchange, the investor is in the same tax position as if the relinquished property was never sold. Investors can always purchase a higher-priced property, but they must pay tax on the difference if they buy for less or reinvest less equity. 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, the 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. However, after renting a property for two years, you can convert it to a second home or primary residence. While the conversion does not trigger a taxable event, the deferred gain remains with the property.
- Beginning on the day you convey title of your relinquished property to a buyer, you 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.
- 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 for your new property 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 use or investment property, be sure to consider if a 1031 exchange can help you accomplish your investment goals. A 1031 exchange can help you build wealth, preserve equity, generate additional cash flow and trade into that place in Stone Harbor you've had your eye on.