

What Is a 1031 Exchange and What Do You Need to Know in 2019?

A 1031 exchange is a way to defer paying capital gains tax on the sale of property under Section 1031 of the Internal Revenue Service code.

Valuable commercial property can present their owners with a dilemma, especially in a hot real estate market.

The owners may very well want to sell, but are afraid of getting clobbered with a big capital gains tax bill given how much more the office building or strip mall is worth now compared to when they bought it years ago.

However, savvy real estate investors and business people know a little trick to defer paying capital gains taxes, and best of all, it's perfectly legal. It's called a 1031 exchange, in reference to Section 1031 of the Internal Revenue Service code.

If you're a real estate investor or business owner looking to sell a commercial property, it can be a helpful rule to know.

What Is a 1031 Exchange?

The IRS code's Section 1031 makes it possible for an investor to defer paying capital gains taxes on an investment property upon its sale -- as long as another, "like kind" property is bought with the profit from the sale of the investment property.

This strategy can reduce your overall tax burden.

In a 1031 exchange, a property owner can swap an investment property for another of a like-kind. But for this to work, the owner whose property you want to acquire will have to want to buy your property in exchange. This is why there are essentially three ways to do a 1031 exchange: A delayed, three-party, or Starker exchange.

In a delayed exchange, a facilitator holds the cash after you sell your property, and uses it to buy its replacement for you. The exchange is then treated by the IRS as a swap.

Normally, when you sell an investment property, you have to pay capital gains tax. Sometimes, because of this, selling a property that has been a burden or bad investment can cost you more than what you make by selling it.

But if you own a rental property or other property that has gained in value from its original purchase price, you could make money using a 1031 strategy. To use the tax deferred strategy effectively, you have to buy a property of similar value to one you sell. In this way, you'll avoid at least temporarily having to pay capital gains tax on the sale.

You will, if you're an investor, cash out at some point and pay taxes. But, meanwhile, you can trade properties without causing a sudden tax obligation. The one sticking point of a 1031 is that both the purchase price and the new loan amount has to be the same or higher on the replacement property.

For instance, if you sold a property for \$1 million that had a \$650,000 mortgage, you'd have to buy a property for \$1 million or more with \$650,000 or more in leverage.

What to Know About 1031 Exchanges

A 1031 Exchange isn't for personal use. It is only for business or investment property.

The tax reform law that passed in December 2017 limited exchanges to only real estate.

Like-kind is relatively vague: Raw land can be exchanged for an apartment building, or a ranch can be exchanged for a shopping center.

An exchange of property that is an exact match is rare, which is why frequently the exchange is delayed by use of a qualified intermediary.

A 1031 Exchange has two crucial, non-negotiable, and non-extendable deadlines: 45 days in which to identify a replacement property, and 180 days in which to close on the new property after sale of the old.

Any cash left over after the sale is a taxable "boot," and will be taxed as capital gain on the sale of your property.

The steps for a 1031 exchange:

1. Sell an investment property
2. hand your capital gains to a qualified intermediary
3. identify a like-kind property with 45 days
4. negotiate with the seller of the like-kind property
5. agree on a sales price
6. have your intermediary wire the capital gains to the title holder or the title company
7. fill out the IRS form
8. If you own a business, and you're thinking of investing in another one, you might also want to consider a 1031 Exchange.

