1031 EXCHANGES ~ simplified ~ for Real Estate Investors
Capital gains taxes - three words that can make or break an investor. These after-the-sale taxes on the profits from selling investment properties can be as high as 30% when you add up both state and federal taxes. Ouch, there go your profit margins. So how can an investor avoid them? One strategy is to utilize the 1031 Exchange to defer those taxes while keeping your money invested in real estate.

The 1031 Exchange is a powerful tool for investors, making it a favorite among many savvy and successful real estate pros. Here are the basics of the 1031 Exchange:

- The “1031” portion of its name comes from the Internal Revenue Code, Section 1031 which outlines the rules of the exchange.
- 1031 Exchanges were officially created in 1984 in order to standardize “like-kind” property exchanges that were previously difficult to regulate.
- This legislation gave further definition to “like-kind” properties, and set strict timetables by which exchanges must adhere to.

What properties qualify for a 1031 Exchange?

The first half of the exchange is the property you currently hold. In order to qualify, this property must be held for business or investment use – meaning no personal residences. What about fix and flips? The answer is typically “no” because the intent of most flips is to acquire, rehab, and sell within a short period of time. In the eyes of the IRS, this does not fit their criteria for eligible properties. But fear not rehabbers! You can still utilize a 1031 Exchange if you rehab a property and rent it out before selling. The IRS sees this as a long-term investment property, and therefore eligible for capital gains tax deferment.
At WCP, we have solutions for investors looking to acquire, rehab, and rent out an investment property so that it can qualify for a 1031 exchange. To secure and rehab the property, you can utilize a **Fix and Flip Loan**, and when the construction is complete you can refinance it into a **Rental Loan** with a 30-year term. This allows you to flip a house using hard money, and qualify the property for a 1031 Exchange by holding it as a cash-flowing property, all with one lender, minimal documents, and minimal effort. Boom.

The second half of the exchange is the property that you intend to acquire. This property must be of “like-kind” to your current property, meaning the property must also be an investment, not a personal residence. Qualified property types include, but are not limited to, office buildings, shopping centers, mixed-use properties, multifamily properties, single family homes, and even undeveloped land. Another option that you can utilize would be a “**Tenants in Common**” property. So if you currently hold a multifamily rental building, you can potentially use the 1031 Exchange to sell that property without paying capital gains taxes, and reinvest in undeveloped land (since it is still considered “like-kind” property).

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**Do I need a Qualified Intermediary?**

According to 1031 Exchange guidelines, you will likely need a **Qualified Intermediary (QI)** to serve as a third-party to accommodate the sale, and hold subsequent payout from your currently held property. The QI also purchases the replacement property on your behalf before deeding it over to you. The entire exchange is facilitated by the QI, and they are the ones hanging on to your money before the replacement property is purchased, so be sure to choose a reputable QI. The demand for legitimate QI’s has led to the creation of businesses, usually tied to title companies, that provide QI services. This is a great place to start, but always ask for references and do your due diligence before picking one for your exchange. While it may not be a flat-out requirement, we highly recommend that you utilize a QI to ensure that your transaction is done correctly and your exchange doesn’t fall through because of title or escrow issues that can be avoided.
What are the deadlines for a 1031 Exchange?

To properly execute a 1031 Exchange, you need to plan ahead. Once the sale of your currently held property takes place, the clock starts ticking on your first time restriction. At that point, you have 45 calendar days to identify your replacement property. The rules allow you to identify 3 (there are some exceptions to that limit) potential replacement properties within the 45-day window, but here’s the catch – one of those identified properties must be the one that you close on. In the world of real estate investing, 45 days feels like the blink of an eye for vetting and selecting properties, so how are you supposed to ensure that you meet this restriction? The answer is to plan ahead. Before that 45-day window even starts, you should be doing all of the necessary legwork to line up your replacement property. The goal here is to set up your timing so that you have your desired replacement property under contract the minute your currently held property closes, and that 45-day window begins. That way, even if the first contract falls through, you’re giving yourself the maximum amount of time to fall back on your next identified property.

Now if a buyer stepped forward for your currently held property as a surprise, planning ahead isn’t going to be very easy. In that scenario, you will probably have to be quick on your feet and highly organized if you want to identify your replacement property just 45 days after your currently held property closes. This isn’t impossible, but it can be hectic.

Your second time restriction also starts ticking as soon as you close on the sale of your currently held property. From that time, you have 180 days to close on the selected replacement property. That’s right, both time limits are activated on the same day, so be mindful that your 180-day limit is not influenced by your 45-day Identification Period. Also, know that no extensions or exceptions will be granted – you have 180 days and not a minute longer. The only event that can change this time limit would be the due date of your tax return. If your return is due before the end of your 180-day window, then that date becomes your new time limit. This is why we can’t stress enough how important planning out your 1031 Exchange is!
Are 1031 Exchanges worth the work?

Yes. Deferring your capital gains taxes is absolutely worth the work. If you intend to keep your money invested in like-kind real estate, you should never have to pay capital gains taxes. With the right planning and guidance from expert counsel, you can defer these taxes indefinitely while holding positive cash-flowing properties throughout your investing career. In theory, you can keep deferring capital gains taxes through 1031 Exchanges until the day that you die. This means that you escape paying the taxes, and your heir receives the property free from the taxes that you owed. This makes a 1031 Exchange a powerful tool for building a cash-flow portfolio using pre-tax dollars and protecting your estate from the IRS. Now that’s a win-win scenario.