# Making the Most of 1031 Real Estate Exchanges

By Nadia Reynolds

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Perhaps you have invested in real estate that no longer makes sense for you, for whatever reason. Could be that the property is providing too little income, requires too much maintenance or you think its value has peaked. Or all of the above. What to do? You might want to consider what is officially known as a "Section 1031 Like-Kind Exchange."

Section 1031 of the US Tax Code allows you to do something interesting and quite beneficial: (1) sell property you no longer want or need; (2) defer taxes on the profit; and (3) re-invest in real estate that generates more income or makes more sense for you in other ways. That's right: you can put off capital gains taxes (and the recapture of depreciation) while reinvesting in a property you want or need.

Sounds great, right? The catch is that you must follow the rules and procedures EXACTLY, otherwise, the transaction will not qualify as a Section 1031 Like-Kind Exchange. That means you might be stuck with a high capital gains tax bill on the sold property, if there has been a big increase in market value combined with a low cost basis (all the depreciation written off over the years will be "recaptured" or subtracted from your original purchase price).

## The Ground Rules

Here are the key things to keep in mind while trying to figure out if a 1031 Exchange makes sense for you:

- Your primary residence does NOT qualify for a 1031 Exchange. It must be an investment property, such as a house or apartment you have been renting out, or a building used by your business.
- Both the property you sell and the property you buy must be titled the same. If the current property is owned by your business, for e xample, then the new property must also be purchased in the name of the business.
- The replacement property must be of equal or greater value to the one you sold. Getting extra cash or additional property (known as "boot") does not disqualify the exchange. However, any "boot" received in the transactions will be taxed as a capital gain.

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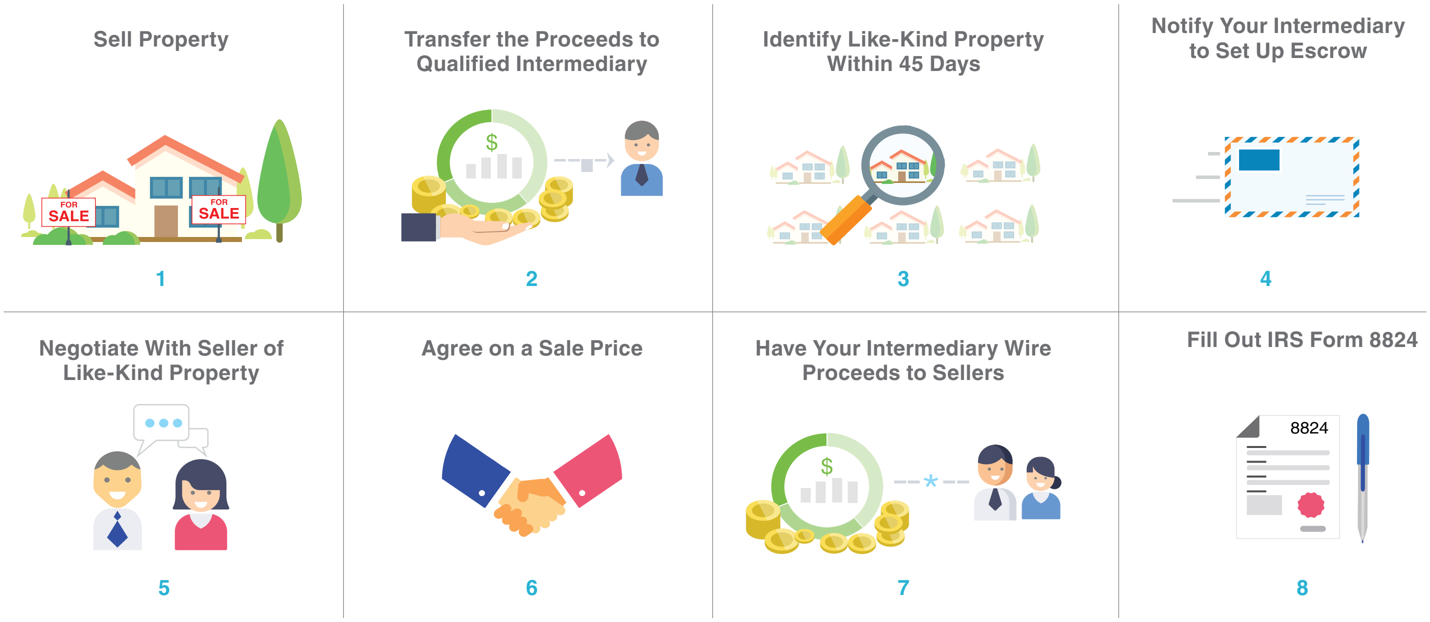
**The 8 Steps of a 1031 Exchange:** 180 Days Start to Finish




- You must use an intermediary. The IRS requires that you hire a Qualified Intermediary, aka a 1031 Exchange Accommodator or Facilitator, to sell and buy. This intermediary must be a third-party to the transaction; it cannot be you or someone related to you.
- Exchanges have strict time limits: 45-Day Identification Period and 180-Day Purchase Period. This means that once you sell the property, you have 45 days to identify another similarly priced property whose owner wishes to sell to you. After that, you have 180 days to close the deal.

## Here's an Example

A Section 1031 Exchange can be especially advantageous if you own investment property in a pricey market, such as the Seattle area, and want to maximize your income for retirement or some other reason. Here's an example of how this can work:

**Problem:** Bill and Mary want more income for their retirement years, and to not worry about repairing rental houses. Let's say they are in their late-50s, with a primary residence in Seattle plus two rental houses in Renton, WA. Both rentals are in need of updates and leased at below-market rates — $1,800 a month each (net $1,500). Estimates are that each house can sell for $450,000, a big gain from the $100,000 purchase price.

**Solution:** With the help of a property manager, Bill and Mary look nationally and find new-construction homes in Memphis, Tenn. priced at $200,000 each. They hire an intermediary to do a Section 1031 Like-Kind Exchange, and then sell their two houses in Renton for a total of $900,000 tax-deferred. The net proceeds from the Renton sale, roughly $800,000, are then re-invested in four new houses in Memphis. Each of the four is then leased for $1,500 a month, or $5,000 total, net of management and maintenance fees.

**Result:** A 67% increase in Bill and Mary's net monthly rental income: to $5,000 a month (up from $3,000). And they now own new rental houses that will require little updating.

The above is just a hypothetical example. If you own investment or business real estate that is not working for you, it's worth exploring a Section 1031 Exchange. Our advice, as always, is that an exchange should be done in context of an overall financial plan that takes into account where you are now and where you want to be years from now. Without a financial plan in place, you risk selling yourself short (pun intended).

### Types of 1031 Exchanges

- **Delayed Exchange (the most common) -** sell a property first, then find and buy a replacement property within 180 days.
- **Simultaneous Exchange -** sell your old property and buy a new one at the same time, all within 180 days.
- **Reverse or Forward Exchange -** agree to buy a new property first, then sell the old one. This can be especially advantageous in hot markets or in situations when you need to act fast on a new listing.
- **Construction/Improvement Exchange -** expand or improve your replacement property as part of the exchange. During that time, all financial transactions pertaining to the property happen through the Exchange Intermediary.

## ABOUT THE AUTHOR

NADIA REYNOLDS is a Senior Client Analyst at Laird Norton Wealth Management. She collaborates wiith other members on LNWM Client Advisory teams to develop and implement financial strategies that allow clients to attain their life goals. Nadia has more than 15 years of experience in the wealth management industry and is involved in all aspects of client account management and financial planning. She is a CERTIFIED FINANCIAL PLANNER™ and has a Bachelor of Arts in Government and International Politics from George Mason University.

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