Season 1 – Episode 8 - Unlocking Real Estate Wealth with 1031 Exchanges - A Comprehensive Guide

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Welcome to Tax Blueprints, a Rohr CPAs podcast. I'm Daniel Rohr, the managing shareholder of Rohr and Associates, a premier CPA firm based in California. I'm a CPA, personal financial specialist and enrolled agent. I have extensive experience advising individuals and business owners with tax minimization and personal financial planning strategies. On each episode of Tax Blueprints, I delve into the intricacies of tax laws, explain the subtleties of business tax planning, and guide individuals towards a path of financial stability. Whether you're a business owner navigating the murky waters of taxation or an individual planning for a worry-free retirement, Tax Blueprints will provide you with the tools and knowledge you need. I hope you enjoy this episode.

Today, we're turning our focus to a tax strategy that's been around for over 100 years, yet remains largely misunderstood by many the 1031 exchange. We'll explore how this provision can be a game changer for investors in real estate, share examples and shed light on how an LLC partnership can transform into a tenancy in common to qualify for 1031. And lastly, we'll dive into the complex world of reverse exchanges. A section 1031 exchange is a provision in the US. Tax Code that allows real estate investors to defer paying capital gains taxes on investment property when it is sold, as long as another like kind property is purchased with the profit gained from the sale of the first property. This exchange is named after its governing section of the Internal Revenue Code, section 1031. Under the IRS guidelines, a 1031 exchange has two significant timing rules that you must adhere to for the transaction to qualify the identification period, this is the time frame within which you must identify potential replacement properties.

This period starts on the day you sell your Relinquished Property and ends at midnight on the 45th day. It's important to note that this rule is absolute. The IRS doesn't grant extensions, and the 45 day window includes weekends and holidays. You're allowed to identify up to three properties of any value or more properties, as long as their total value doesn't exceed 200% of the value of the property being sold. Your identifications must be in writing. They must be signed by you and delivered to a person involved in the exchange, like the seller or the qualified intermediary. Descriptions of the property must be unambiguous and, for example, legal description or a street address. Now, the second part is the exchange period. This is the time within which you must acquire the replacement property. The exchange period begins on the date you sell the Relinquished Property and ends at midnight on the 180th day.

Now, in addition to the strict timing rules, a 1031 exchange must be handled by a qualified intermediary, or Qi, also known as an exchange accommodator. The Qi plays a critical role in the process, holding the proceeds from the sale of the Relinquished Property and then using those funds to acquire the replacement property. The involvement of the Qi is a crucial element of the exchange. If you were to receive the sale proceeds directly, the exchange would be disqualified and the transaction would become taxable. Keep in mind that the Qi must be involved in the transaction before the sale of the relinquished property closes, they'll prepare the necessary exchange agreement and other required documents. It's also important to know that your Qi cannot be someone you've had a family or financial relationship with during the previous two years, like a lawyer, a real estate agent, accountant, or of course, a relative.

This is typically not an issue though, as taxpayers are going through 1031 exchange will hire a specific Qi company to handle the transaction. Now, let's put this into perspective with a pretty basic example. Say you have an investment property that you bought for $200,000, and then you later sell it for $300,000. The gain is obviously $100,000. Now, normally you'd have to pay capital gains tax on the $100,000. Now, if you decide to invest this 100,000 into another investment property, the 1031 exchange allows you to defer paying the tax. And this example doesn't involve a mortgage or involve the concept of a tax term called boot. Boot and a mortgage can make the 1031 exchange a bit more complicated. So let's use the same numbers as before with a 300,000 sale price. Assume you had a mortgage of $150,000 on the property at the time of the sale.

After paying off the mortgage, you're left with 150,000 in cash, which is the 300,000 sale price minus the

150,000 mortgage. Under the rules of the 1031 exchange, you decide to purchase a new investment property for $350,000. For this purchase, you use the $150,000 cash from the sale of your old property and take a new mortgage of 200,000 to cover the balance. Now, here's where the terms debt and boot come in. In a 1031 exchange, not only do you have to reinvest all of the proceeds of the sale the $150,000 cash in this example but your new mortgage should be equal to or greater than your old mortgage to fully defer your capital gains tax. So in our example, since the new mortgage of 200,000 is larger than the old mortgage of 150,000, you've met this requirement and therefore you've successfully deferred the capital gains tax on your 100,000 profit.

But what if your new mortgage was only 100,000? In this case, you would have 50,000 of mortgage boot. And because your new debt is 50,000 less than your old debt, this 50,000 would be considered taxable income and you would not be deferred by the 1031 exchange. Now additionally, let's say that you decided to keep 20,000 of your cash from the sale instead of reinvesting the entire amount. This is considered cash boot and would also be taxable. Now in this scenario, with both mortgage and cash boot, you would owe capital gains tax on $70,000. Even though you performed a 1031 exchange, the remaining gain of 30,000 would still be deferred. Now, how does it work when the property you want to exchange into is worth more than the property you sold? And this is considered buying up. And depending on the circumstance, this can allow you to accelerate depreciation deductions on the increased value of the transaction.

So consider this you've sold your rental property you initially purchased for 200,000, and this time you sold it for 500. After repaying your remaining mortgage of 150,000, you're left with 350 from the sale. You decide to execute a 1031 exchange and buy another rental property for 600,000. To cover the cost, you use the 350 from the sale and secure a new mortgage for remaining 250. Here you've bought up in price and mortgage, thus fully deferring your capital gains tax. Now your base of the new property becomes the purchase price 600,000. If you were to conduct a cost segregation study. And the study identifies that 100,000 of the property's cost is attributable to items classified as personal property, like appliances or carpet or cabinetry and land improvements such as landscaping or your driveway. These items have shorter depreciation lives and can be depreciated over five, seven or 15 years, rather than 27 and a half years for a residential building or 39 years for a commercial building.

Under current tax law, the five, seven or 15 year life assets qualify for 80% bonus depreciation in the year the property is placed in service. So this means that you can deduct, in our example, $80,000 in the first year, providing a substantial upfront tax deduction. So the previous examples were straightforward in terms of ownership. Now, sometimes you may own real estate in a partnership or an LLC with other members. If the partnership or LLC decides to sell the property outright, you pay taxes on your portion of the gain. Unfortunately, you can't perform a 1031 exchange of partnership or LLC ownership interests themselves. Now, that said, there's a way around this issue. Using proper planning, you can use a tenancy in common or tick ownership. A tick arrangement allows two or more people to hold title to a property. Now, each owner can own a different percentage of the property and can sell, lease or will their individual ownership interest to anyone else.

And by converting a partnership or an LLC ownership to a tick, each member can sell their individual share in the property as part of a 1031 exchange. So for instance, if two partners in an LLC own an investment property and one wants to cash out while the other wants to do a 1031 exchange, the LLC could be dissolved and the property could then be converted to a tick. And each partner can then deal with their shares as they see fit in allowing one partner to cash out, pay their capital gains tax and the other can roll their share into a new investment property through a 1031 exchange. Another important issue with selling real estate through 1031 occurs when you have a replacement property in mind and you're ready to purchase it, but you do not currently have a buyer for the property that you want to sell.

This is where you can use a reverse exchange. To illustrate, let's say that you come across a perfect investment property that you want to buy, but you haven't sold your current property yet. You could buy this new property first and then sell your old property within 180 days. The IRS lets you park the new property with a qualified intermediary until the old one is sold. It's important to remember, though, that during this parking period, while the replacement property is held by the intermediary, the investor can manage the property and even collect rents, except that the exchanger must respect certain guidelines, such as not being able to improve the property during this parking period. Now, once the old property is sold within 180 day time frame, the intermediary transfers the title of the new property to the investor and the 1031 reverse exchange is completed. Reverse exchanges can beneficial, but they can also be a bit more complicated than a standard 1031 exchange, mainly because they require all cash to close the replacement property purchase.

And you cannot use bank financing when the property is parked with the intermediary. Therefore, you'll need to ensure that you have the necessary funds or alternate financing before pursuing a reverse exchange. Whether it's a regular 1031 exchange, converting an LLC to a tick arrangement, or undertaking a reverse exchange, it's clear that these strategies offer significant tax advantages for real estate investors, but they're also complex and full of potential pitfalls. Also remember, the IRS is extremely strict about the rules surrounding 1031 exchanges, so it's crucial to work with a qualified professional who has experience in these matters. Each misstep can lead to disqualification of the 1031 exchange, which means the deferral of your capital gains tax vanishes.

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