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NEWSLETTER

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How to Use a 1031 Tax-Deferred Exchange to Maximize Cash Flow

By David Tran

The World without 1031 Tax-Deferred Exchange

Let's say you bought a residential property in the Bay Area for $250K twenty five years ago and financed it with a $160K loan. Since the property is located in a good area, its value has appreciated to $1M. Over the years, you refinanced the original loan to consolidate your other debts and currently owe $200K on the property. Each month, you collect $2,500 of rent. After paying $1,800/month for the loan, $350/month for property taxes and $55/month for insurance, you barely have any money left to pay for maintenance and other expenses.

As you grow older, you realize that you need a second source of reliable income; so, you are not completely dependent on your salary. Your company says its employees are its most valuable assets, but it also outsources many jobs to China and India to cut costs. You know you should not blame your company. It has to remain competitive. So when you see an attractive multi-tenant shopping strip in a middle-class suburb of Dallas, 100% NNN lease with $195K/year of Net Operating Income (income after all expenses except the mortgage payment) on the market for $2.6M offering 7.5% cap, you get excited!

Since the residential real estate market in the Bay Area has been very favorable, you consider selling your rental property to buy this shopping strip. You estimate that you would have to pay about $200K in federal and state income taxes on $800K of capital gain ($1M less $250K purchase price and selling fees, plus $50K in depreciation recapture). You just hate having to pay $200K to the government – money that may go toward your down payment on the shopping strip. There is a better way – a way to defer the income tax.

What is a 1031 Tax-Deferred Exchange?

Section 1031 of the Internal Revenue Code generally provides that neither gain nor loss is recognized if qualifying property is exchanged for other qualifying property of a like-kind. In the above scenario, you may defer the payment of $200K in both federal and state taxes if you acquire another investment property with equal or greater debt and equal or greater equity. In other words, if you buy another investment real property for $1M or more, using all of the net proceeds as down payment, then you may defer the $200K of taxes. Essentially, the government would lend $200K to you, without interest. And you may repeat this deferral and never pay income taxes.

How Do You Qualify for a 1031 Exchange?

You must comply with several strict rules. Failure to satisfy any of the rules will disqualify your transaction from a 1031 tax-deferred exchange.

- You must trade up. The property you buy (replacement property) must have an equal or greater debt AND an equal or greater equity than the property you sell (relinquished property). This means you must put all of the net proceeds from the relinquished property to the replacement property and the fair market value (FMV) of the replacement property must be more than the FMV of the relinquished property.
- The qualifying property must be of like-kind. The relinquished and replacement properties must be held for productive use in a trade or business or for investment, before and after the exchange. And one kind of property may not be exchanged for property of a different kind. For instance, you may not exchange a residential rental property

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for one you intend to occupy as your principal residence – not qualifying property. And you may not exchange a factory for equipment – not like kind. On the other hand, residential and commercial real properties are of like kind. So, you may exchange a residential rental property for a shopping center.

- In a delayed exchange, you must identify the replacement property within 45 days and receive it within 180 days from the closing date of the relinquished property or by the due date of your tax return (with extension) whichever is sooner.
- You may identify up to 3 replacement properties and must close escrow with at least 1 of the 3. Alternatively, you may identify as many properties as you want as long as the total value of these properties does not exceed 200% of the value of the relinquished property.
- You should have an exchange intermediary hold the sales proceeds of the relinquished property. Most investors use an exchange company as the qualified intermediary for a delayed 1031 exchange.
- If you exchange a property with a related person (your children, parents), then both parties may not dispose the properties within 2 years. If the sale proceeds are deposited in an interest bearing account during the exchange, you must receive the interests AFTER the close of escrow of the replacement property.

What Expenses are Permissible?

You can use 1031 proceeds to pay for a certain selling expenses of the relinquished property and buying expenses for the replacement property: owner's title insurance premiums, escrow agent or closing attorney's fees, real estate broker's commissions, 1031 exchange intermediary's fees, document transfer taxes, record fees, and tax advisor fees. You cannot use 1031 proceed to pay for these expenses: loan fees/points, appraisal fees, mortgage insurance premiums, lender's title insurance policy premiums, property insurance premium, repairs and/or maintenance costs.

Strategies for a Successful 1031 Exchange

The following strategies are intended for investors looking for commercial property as a replacement property.

- Have 3 plans for your 1031 exchange: A, B, and C with plan A being the best case and plan C being the worst case. Have at least one different property for each plan.
- Start looking for a replacement property early. Since you have only 45 days to identify replacement properties, you should make an offer as soon as the relinquished property is in escrow. By the time you close escrow on the relinquished property, you should have one offer accepted on a replacement property. This first property does not need to be the most desirable property at the best price. Mentally, you should think of it as a plan-C property for the worst case scenario. That way, you don't wait till the last minutes to make an offer. It is also intended to take away your worries such as "Oh my God, what if I cannot find a replacement property?" so you sleep well.
- Specify a 30-day due diligence and cancellation period in the contract. This will give you more time to specify more than 1 property.
- Think twice about choosing a replacement property with loan assumption. It's much harder to get lender approval for loan assumption than for a new loan. Moreover, you have only once chance to get approval for loan assumption versus many chances to get a new loan approved. You don't want to have your loan assumption denied by the lender after the 45 day identification period.

Questions for a 1031 Exchange Intermediary

Technically, you don't need a 1031 exchange company to handle the exchange. However, it is advisable to have an expert assist you. This company will ensure that you comply with strict IRS rules. To decide which company to assist you, you should consider:

- The fee is around $500-$750 per transaction. The company that charges less tends to limit you to 3 replacement properties and the company that charges more may not have that limit.
- Whether your proceeds will be deposited in a separate trust account or commingled with the company's main account. In the event that the company goes under, you don't want your money stuck in that company's account while the 45 day period expires.
- Whether your proceeds will earn any interests and the money is insured.

What if you want to buy the replacement property first?

For some investors, the strict 45 day identification period and 180 day exchange period may be too short. The alternative is to consider a reverse exchange. It is a transaction in which the replacement property is owned by an intermediary party during the pendency of the like-kind exchange until the taxpayer is able to sell her relinquished property. Then the replacement property is exchanged to the taxpayer. A reverse delayed exchange is an advanced strategy, and you should consult a tax advisor to guide you.

The Happy Ending

Your offer of $2.6M for the shopping center is accepted. The bank lends you $1.82M (70% LTV) at 4.5% interest amortized over 25 years. After paying $10,116/month for the mortgage, you still have over $6100 a month positive cash flow! Now you realize Uncle Sam is very smart. He allows you to have a tax-deferred exchange so you can maximize your profits. In return, he may collect more taxes later. And you are OK with that as both you and Uncle Sam win.