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The 1031; Tried and True and Maybe For You

Preservation of capital, income, and wealth creation – these are common interests on the minds of investors. Another critical topic people are thinking about is how to manage the impact of taxes on their investments. For those investors that own investment property there is something called a 1031 exchange available which allows them the potential to continuously put off paying their tax bill. Does this sound interesting? If so, continue along with us to learn more about how this relates to investment property ownership and how to take advantage of beneficial tax treatment.

To even consider a 1031 exchange an investor must have an investment property(s). Many investors own direct real estate in their portfolios and in some cases, properties are owned for generations. In other situations, the owners come to a point when it's time to sell. So, what happens then?

This is when the critical topic of taxes comes front and center. Assuming an investor is in a position to sell with a gain, they can do one of two things:

1. Sell the property and pay taxes on the difference between their net return and their basis
2. Find a "like-kind" property and follow a specific, intermediated process to use the capital from their sale to *exchange* their ownership.

Which path an investor chooses really depends on how they view the purpose of holding real estate and if they need or want that after tax capital gain in the near term. For the remainder of this commentary, we will assume the goal is to exchange ownership.

The concept of a 1031 exchange has been around since the early 20th century. That's right, people had the ability to swap real estate in a tax advantaged way before they could invest in a mutual fund. This tax advantaged exchange transaction is a virtue of the Revenue Act of 1921.

We've been referencing the 1031 as a tax advantaged transaction. The advantage is that an investor can defer their tax bill if acquiring another investment property. Deferring taxes is usually a helpful way to manage the year-to-year impact of income changes. What is really enticing about 1031 is that the taxes associated with a capital gain can be deferred indefinitely! Don't check your glasses prescription or the resolution on your phone, you read that correctly. If done correctly, and assuming the second leg of an exchange is held continuously, the tax bill will be deferred. This is a valuable tool for managing tax exposure and an even more impactful tool for estate planning.

Does this sound too good to be true? Perhaps many of you are thinking this is simply sensational words intended as an attention grab. Assuredly this is not the case. The 1031 exchange is alive and well and is available for all to take advantage of under the appropriate circumstances.

To better understand a 1031 exchange let's take a 30,000-foot level look at what it typically involves. It is important to acknowledge and understand that there is a specific process that must be followed in order to realize the tax benefits:

- Step 1: Own an investment property that has appreciated in value: The property being sold to start a 1031 exchange must be an investment property and not a primary residence.
- Step 2: Arrange the proper professional resources: unlike a typical real estate sale, you will need specialists including what's known as a qualified intermediary ("QI"). Think of the QI like an escrow account. Rather than you receiving the proceeds of the sale, they go to the QI to preserve the purity of the process.
- Step 3: Identify the property you would like to acquire next: In order for the tax benefits to take effect in full, an investor needs to roll the entirety of their proceeds (net of commissions, etc.) into acquiring a separate, "like-kind" asset. It's important to know that this new asset can be a single property or an interest in a shared investment vehicle. We'll get into this difference further below.
- Step 4: Complete the acquisition of the new asset: the investor has 180 days to complete the closing of a new asset.

There are steps within each of these steps but generally this is the outline of the 1031 exchange process. It is really important for investors to not only understand and follow these steps, but also to ensure that they are making an exchange of "like-kind" property. What exactly does like-kind mean? Basically, it means that an investor can exchange a previous investment property for a new investment property – they don't have to be the same type of building.

Equipped with these basic concepts investors gain awareness of a powerful real estate tool. If you own an investment property and want to maximize the value, maybe now is the time to sell and maybe through a 1031 exchange. You'll need to identify the like-kind property that will complete the exchange. Keep in mind that the like-kind property can be another single asset, or it can be an interest in a portfolio. When thinking about making a 1031 exchange, you get to decide if you want to actively own property or if you want to be more passive in your next investment.

One of the more common pooled, portfolio options available to complete a 1031 exchange is a Delaware Statutory Trust ("DST"). The DST is operated by a third-party investment manager that identifies, acquires, and oversees the assets of the portfolio.

Probably not surprisingly there are some nuances to the DST. For one thing, holding an interest in a DST means you would own a portion of a diversified portfolio of investment properties, actively managed by the investment manager. Like other investments funds, the manager will seek to build a portfolio of attractive properties. The other thing is that there is a generally defined holding period, unlike the investment property that may have been exchanged originally. In the DST, the investment manager will add value to the portfolio over a 5 – 10-year time frame and will then unwind the portfolio and return capital to investors.

When a DST winds down investors are faced with another decision. You guessed it, do you cash out and pay taxes on gains, or do you cycle through another exchange. So long as investors can continue to identify like-kind properties and follow the 1031 exchange process, they can continue to defer taxes. This is the remarkable point that ties into estate planning. If an investor holds 1031 exchange property, passes away, and has named beneficiaries, the beneficiaries get a stepped-up basis on the property. Translation, the beneficiaries' cost basis is equal to the fair value of the property when inherited.

The 1031 exchange is one of the more impactful tax strategies. Investors can continuously roll over their investment proceeds so long as they find an appropriate, next property to buy. This strategy gives investors flexibility with their taxes and the ability to pass along appreciated property through their estate without the burden of a big tax bill to their beneficiaries. There is a lot to like about the 1031 exchange. Just remember to pay attention to the details.

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