7 MISCONCEPTIONS

Third Edition

You can't trust everything that you read on the Internet

1031X
QUALIFIED INTERMEDIARY

MISCONCEPTION 1

"To defer all income taxes in an Exchange, you only need to reinvest the net cash from your sale."

This is a very common misunderstanding. While it is true that full tax deferral does require that you reinvest all of your net cash proceeds, following this rule alone will often result in large tax consequences and inefficient 1031 exchanges.

THE TRUTH IS that deferring all income taxes in a 1031 exchange requires that you:

1. Trade into replacement property of equal or greater value*
2. Use as down payment all of your cash proceeds from sale, such that you have equal or greater equity in the new property.

(*Here, "value" means the sales price net of closing costs)

Having to reinvest into property of equal or greater value does mean that you will have a hard time deleveraging with a 1031 exchange; then again, most real estate investors consider leverage a useful tool.

Example: You sell an investment property for $500,000. After $25,000 in closing costs and paying off the $250,000 mortgage, you have $225,000 in net cash proceeds.

To fully defer your taxes with a 1031 exchange, you must purchase new property(ies) worth at least $475,000 — equal to your net sales price — and put all $225,000 in net cash proceeds as down payment on the new property(ies).

MISCONCEPTION 2

"You must trade 'equal or up' in debt to fully defer income tax in a 1031 exchange. "

THE TRUTH IS that to satisfy tax deferral in a 1031 exchange, you must always replace the full value (net sales price) and use all of your cash proceeds as down payment to replace the equity. However, you can replace the value of your debt **with outside cash**.

You will read this all over the internet.

"You must replace the debt on your old property with equal or greater debt on the new property"

While there is some technical basis for this claim, practically this is not true. It is often the case that your new property in a 1031 exchange will carry equal or greater debt, but it need not be so.

Example: You sell an investment property for $500,000. After $25,000 in closing costs and paying off the $250,000 mortgage, you have $225,000 in net cash proceeds.

To fully defer your taxes with a 1031 exchange, you do not need to get a new mortgage of at least $250,000. (You can, but don't have to). Rather, you could replace the mortgage by just bringing in $250,000 of outside cash. Or you could bring in $100,000 of outside cash and then get a new mortgage of $150,000. Or any combination that you can think of.

MISCONCEPTION 3

"If you take cash out of sale when you start a 1031 exchange, you cannot exchange the remainder."

It is true that any cash you pull out from a 1031 exchange sale will become recognized and taxable; it is **not true** that this means you cannot perform a 1031 exchange and defer the rest of your tax liability.

THE TRUTH IS that so-called "partial" 1031 exchanges are common and legal. If you need to pull some cash out of your sale, do so. Just remember that this will reduce the tax efficiency of your exchange.

It is also possible to refinance your relinquished property or replacement property and acquire tax-free cash. Borrowed money is not considered income (because it carries the risk of default and burden of repayment). Tread very carefully here, as refinances are not always considered value by the IRS when executed on the relinquished property immediately prior to a 1031 exchange.

Example: You sell an investment property for $500,000. After $25,000 in closing costs and paying off the $250,000 mortgage, you have $225,000 in net cash proceeds. Rather than reinvesting all of the net cash proceeds, you elect to take $50,000 out as cash at closing and exclude them from the exchange.

This means that you will instantly recognize $50,000 in taxable income, but the rest of your tax liability (to the extent that it is greater than $50,000) can be deferred.

Keep in mind that this will lower your reinvestment requirement in terms of net value; you will now only need to purchase for $425,000 and put $175,000 down toward your next property.

MISCONCEPTION 4

"Your tax basis in the new property will reset to the purchase price after a 1031 exchange."

THE TRUTH IS that your tax basis does not reset in a 1031 exchange; rather, your basis transfers into the new property using the following formula:

- Find the basis of your relinquished property.
- If the replacement property(ies) are more valuable than what you sold, add the difference in net value to your old basis.

"Tax basis" is a very important concept for determining future tax liability and potential future depreciation expenses.

Whenever you purchase a new property **outside of a 1031 exchange**, your tax basis is equal to the purchase price.

This is not so in a 1031 exchange.

Example: You sell an investment property for $500,000. After $25,000 in closing costs the net value of your property is $475,000. You and your tax preparer calculate that your adjusted tax basis in the property at the time of sale was $315,000.

You then purchase a replacement property worth $600,000.

The new property ($600,000) is worth $125,000 more than the net sale price of your old property ($475,000). So your new tax basis is equal to the old basis ($315,000) plus the difference in value ($125,000), giving you a new tax basis of $440,000.

MISCONCEPTION 5

“Any 1031-acquired investment property can be converted into a primary residence, lived ed in for two years, then sold tax-exempt under IRC § 121.”

It is common for real estate investors to target their retirement home (or any future residence) through a 1031 exchange. Here’s the typical strategy:

1. Buy the property through a 1031 exchange
2. Renting it for out for at least two years
3. Move in

There is nothing wrong with this approach. However, many also assume that they can subsequently sell their new home two years later and claim the very generous tax exemption for primary residences.

THE TRUTH IS that if you do convert a 1031 replacement property into a principal residence, the application of IRC § 121 will be limited. To start, you must own the property for at least a total of five years, including the investment portion. Long-term capital gains will be prorated based on how long the property was held for investment purposes vs. how long it was used for a principal residence.

No matter how long you occupy the property, you will always have to pay tax on all of the recaptured depreciation and some prorated portion of the long-term capital gain.

(*Here, “value” means the sales price net of closing costs)

Having to reinvest into property of equal or greater value does mean that you will have a hard time deleveraging with a 1031 exchange; then again, most real estate investors consider leverage a useful tool.

Example: You own a rental property for six years. You then 1031 exchange into a new rental property. Four years later, you elect to convert the property into a principal residence. After living there for five more years, you then decide to sell and claim your IRC § 121 capital gains exemption.

The total investment lifetime of the asset is equal to 10 years (six with old property; four with new).

The total residential lifetime of the asset is equal to 5 years.

This means that only 1/3rd of the lifetime of the asset can be prorated for (and exempted under) IRC § 121. You will still have to pay fully 2/3rd of the long-term capital gains upon sale, plus any depreciation recapture from the investment period.

MISCONCEPTION 6

"Vacation homes are 1031 exchange-eligible."

Your vacation home lives in an unfortunate "no-man's land" as far as tax purposes are concerned.

THE TRUTH IS that vacation homes only qualify for tax-deferral under IRC § 1031 if you limited your personal use to the property for no more than 14 days per year, or 10% of the number of days that you rented the property, whichever is greater.

In addition, it is best if you have owned the property for at least 24 months immediately prior to the 1031 exchange, and that you have rented the property for at least 14 or more days in each of the subsequent 12-month periods.

Rent assessed at a vacation home should be at or near "fair market rent" given the asset quality and location.

Example: You own a second home in Florida. You rent this property for an average of 172 days per year. To qualify for tax-deferral under section 1031, you must limit your personal use to no more than 17 days* per year.

*Days spent performing maintenance and repairs do not count against you for this calculation.

MISCONCEPTION 7

"Real estate must be used similarly to be considered 'like-kind' in a 1031 exchange."

THE TRUTH IS that effectively any asset considered real estate will be considered "like-kind" to your property. You could trade from a SFR into multifamily, commercial, raw land, oil & gas rights... the list goes on and on.

However, all 1031 exchange properties must be held for qualified use in trade or business. This is known as the "qualified use test".

Let's imagine that you're selling a single family rental. You want to do a 1031 exchange. Does this mean that you need to reinvest into another single-family rental?

No.

All of the following are considered like-kind.

- Single Family
- Multi Family
- Commercial
- Resort
- Farm & Ranch
- Storage Facility
- Net Lease
- Unimproved Land
- Water Rights
- Oil Rights
- Timber Rights
- TIC Property
- Option to purchase real estate
- Fractional Interests
- Conservation Easement
- Termination of Tobacco Quota
- Transferable Development Rights
- Delaware Statutory Trust