Interested in 1031 Exchanges? What You Need to Know to Protect Your Investments

Posted on 11/20/13

A 1031 exchange is a transaction where an investor can actually replace one investment asset with another comparable investment and incur no tax or have limited tax liability at the time the exchange takes place. These types of transactions are becoming popular with both experienced and novice investors as a way to build wealth within retirement accounts. With that being said, investors must become familiar with the quirks of 1031s (and there are a few) and also realize it is critical to seek the advice of tax professionals to assist in proper execution of these transactions (because of those quirks).

The following is an excerpt from an article Ten Things to Know About 1031 Exchanges written by Robert W. Wood, a tax lawyer with a nationwide practice based out of San Francisco, CA. The article was first published on Forbes.com in 2010. A link to the original article appears at the end of this blog along with more information about Mr. Wood, his experience and his practice.

Ten Things to Know About 1031 Exchanges

1. A 1031 isn't for personal use.

The provision is only for investment and business property, so you can't swap your primary residence for another home. There are ways you can use a 1031 for swapping vacation homes, but this loophole is much narrower than it used to be. For more details, see No. 10.

2. But some personal property qualifies.

Most 1031 exchanges are of real estate. Yet some exchanges of personal property (say a painting) can qualify. Note, however, that exchanges of corporate stock or partnership interests don't qualify. On the other hand, interests as a tenant in common (sometimes called TICs) in real estate do.

3. “Like-kind” is broad.

Most exchanges must merely be of “like-kind”—an enigmatic phrase that doesn’t mean what you think it means. You can exchange an apartment building for raw land, or a ranch for a strip mall. The rules are surprisingly liberal. You can even exchange one business for another. But again, there are traps for the unwary.

4. You can do a “delayed” exchange.

Classically, an exchange involves a simple swap of one property for another between two people. But the odds of finding someone with the exact property you want who wants the exact property you have are slim. For that reason, the vast majority of exchanges are delayed, three party, or “Starker” exchanges (named for the first tax case that allowed them). In a delayed exchange, you need a middleman who holds the cash after you “sell” your property and uses it to “buy” the replacement property for you. This three party exchange is treated as a swap.

5. You must designate replacement property.

There are two key timing rules you must observe in a delayed exchange. The first relates to the designation of replacement property. Once the sale of your property occurs, the intermediary will receive the cash. You can’t receive the cash or it will spoil the 1031 treatment. Also, within 45 days of the sale of your property, you must designate replacement property in writing to the intermediary, specifying the property you want to acquire.

6. You can designate multiple replacement properties.

There’s long been debate about how many properties you can designate and what conditions you can impose. The IRS says you can designate three properties as the designated replacement property so long as you eventually close on one of them. Alternatively, you can designate more properties if you come within certain valuation tests. For example, you can designate an unlimited number of potential replacement properties as long as the fair market value of the replacement properties does not exceed 200% of the aggregate fair market value of all the exchanged properties.

7. You must close within six months.

The second timing rule in a delayed exchange relates to closing. You must close on the new property within 180 days of the sale of the old property. Note that the two time periods run concurrently. That means you start counting when the sale of your property closes. If you designate replacement property exactly 45 days later, you’ll have 135 days left to close on the replacement property.

8. If you receive cash, it’s taxed.

You may have cash left over after the intermediary acquires the replacement property. If so, the intermediary will pay it to you at the end of the 180 days. That cash—known as “boot”—will be taxed as partial sales proceeds from the sale of your property, generally as a capital gain.

9.You must consider mortgages and other debt.

One of the main ways people get into trouble with these transactions is failing to consider loans. You must consider mortgage loans or other debt on the property you relinquish, and any debt on the replacement property. If you don’t receive cash back but your liability goes down, that too will be treated as income to you just like cash. Suppose you had a mortgage of $1 million on the old property, but your mortgage on the new property you receive in exchange is only $900,000. You have $100,000 of gain that is also classified as "boot," and it will be taxed.

10. Using 1031 for a vacation house is tricky.

You can sell your primary residence and, combined with your spouse, shield $500,000 in capital gain, so long as you've lived there for two years out of the past five. But this break isn't available for your second or vacation home. You might have heard tales of taxpayers who used a 1031 to swap one vacation home for another, perhaps even for a house where they want to retire. The 1031 delayed any recognition of gain. Later, they moved into the new property, made it their primary residence and eventually planned to use the $500,000 capital gain exclusion.

In 2004, Congress tightened that loophole. Yes, taxpayers can still turn vacation homes into rental properties and do 1031 exchanges. Example: You stop using your beach house, rent it out for six months or a year and then exchange it for other real estate. If you actually get a tenant and conduct yourself in a businesslike way, you've probably converted the house to investment property, which should make your 1031 exchange OK. But if you merely hold it out for rent but never actually have tenants, it's probably not. The facts will be key, as will the timing. The more time that elapses after you convert the property's use the better. Although there is no absolute standard, anything less than six months of bona fide rental use is probably not enough. A year would be better.

There are a few other points to ponder regarding using a 1031 exchange for a vacation house that can be found by viewing Mr. Wood's entire article which can be accessed at the link provided below. Overall, the above ten points should give you a head start in becoming knowledgeable with 1031 exchanges, the rules, and the complexities of these types of transactions. When used correctly, 1031s have the potential to boost the earnings in your retirement account.

Robert W. Wood is a tax lawyer with a nationwide practice (www.WoodLLP.com). The author of more than 30 books including Taxation of Damage Awards & Settlement Payments (4th Ed. 2009 with 2012 Supplement, **www.TaxInstitute.com**), he can be reached at Wood@WoodLLP.com. This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.

View Mr. Wood's full article on Forbes.com by visiting: **http://www.forbes.com/2010/01/26/capital-gains-tax-1031-vacation-home-personal-finance-robert-wood.html**

For more information regarding 1031 exchanges in your self-directed IRA please contact Jack Callahan, J.D., CFP™, Managing Partner of Advanta IRA Services at (727) 581-9853 or via email at jcallahan@advantairagroup.com.