Stepp & Rothwell

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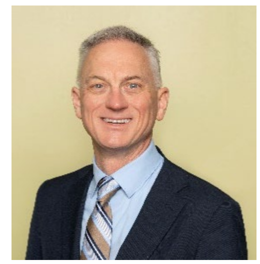
Trading Places? The Ins and Outs of the 1031 Exchange



-Ken Eaton CFA, CFP

If you own real estate, you could be in for a big surprise when you decide to sell it. As with any investment asset, the Internal Revenue Service will assess a capital gains tax on the appreciation of the property at the time of sale, meaning you have to pay tax on the total sale minus what you paid for it originally plus the cost of improvements. In addition, if the property was being rented, and you as the landlord took depreciation deductions on previous tax bills, all of that depreciation is "recaptured" and taxed at a rate that exceeds the capital gains rate. When faced with such a potentially hefty tax bill, it is natural to look for a way to avoid or defer it. That may lead you to consider a 1031 exchange.

The 1031 exchange is a special IRS provision that allows you to swap one piece of real estate for another without paying tax. As long as the purchase price of the new property is equal to or greater than the sale price of the old property, the tax is suspended. The old cost basis (the amount that you paid for the first property plus improvements minus depreciation) carries over to the new property, and then you pay the tax if and when you sell the new property. If the new property costs less than the old property, though, you will still have to pay a proportional amount of tax after the sale.

The rules governing 1031 exchanges can be complicated. To take advantage of the 1031 exchange, you have a set time period in which to identify and close on a replacement property, starting with 180 days before the sale of the old property and ending 180 days after. In a 1031 exchange, however, you are not allowed to take possession of the sales proceeds, so, to use this provision, you have to employ a "Qualified Intermediary" to facilitate both the purchase and sale transactions for you. The added time and expense to find and hire an intermediary should be factored into your consideration of a 1031 exchange.

To qualify for a full 1031 exchange, you have to reinvest the entire proceeds, including the amount of any debt that was repaid upon the sale. So, if you have a large mortgage on the property, you either need to have a mortgage on the new property or come up with the cash to make up the difference. Additionally, the property must be held primarily for investment purposes. A vacation home, for instance, would not normally qualify. Likewise, it cannot be a property held primarily for resale, so you cannot use the provision to flip houses. It is also important to keep in mind that the tax bill will still be due when you sell the next property unless you then exchange it for another one.

In summation, if you are forced to sell your real estate, or you receive an offer too enticing to refuse, but you still want to remain invested in real estate, <u>and</u> you can find another property that you like in time, <u>and</u> you can deal with the added time and expense of an intermediary, the 1031 exchange can be a good way to put off your tax bill. Most people, however, sell their real estate because they are tired of managing it and they need the liquid cash. In that case, it makes sense to simply bite the bullet and pay the tax. Of course, if you are in the position to make that decision, contact us, and we will help you make the right one for you.

CONGRATULATIONS TO THE GRADUATING CLASS OF 2023!

Reality Check
The average college graduate expects a starting salary of $85,000, down from $103,000 in 2022.
The actual starting salary for this year's college grad will be about $55,000.

Pay Check
The highest starting salaries go to computer science and engineering majors. The lowest average salaries go to those in the arts and education.

Gut Check
The student loan "pause" that was initiated during Covid officially ends on June 30th. Interest begins to accrue and payments start coming due 60 days after that.