

# 1031 Insider

March 2013

## TOP TEN MISCONCEPTIONS ABOUT 1031 EXCHANGES

1. **“Like-kind” means I must exchange the same type of property, such as an apartment building, for another apartment building.** *No! Like-kind is an unfortunate misnomer within the context of real property. 1031 exchanges are often called “like-kind exchanges” because that is the language used in the tax code. And there’s the rub: “like-kind,” in effect, simply means that as long as you’re selling real property somewhere in the USA and then buying/exchanging into some other real property located somewhere in the USA, then you’re OK. Exchanges can be done anywhere in the country and can cross state lines. If you sell a rental condo, you do not necessarily have to exchange into another rental condo! You could exchange into raw land, or a strip shopping mall, or a commercial office building, etc. So let’s recap: all real property is like-kind to other real property. Although most 1031 exchanges are done with real property, exchanges can be done with aircraft, artwork, machinery, business vehicles... just about anything that has a capital gain tax can be exchanged. We call these non-real property items “personal property.” The term “like-kind” means that you can’t exchange real property for an aircraft. You can’t exchange machinery for artwork. But in the context of real property, always remember that all real property is like-kind to all other real property.*
2. **A 1031 exchange means that the sale and the purchase have to happen at the same time. In other words, the seller has to find someone willing to swap properties.** *No! The odds of you finding someone else with the exact property that you want – and who wants the exact property you have – are slim. For that reason the vast majority of exchanges are “delayed exchanges” in which you can sell your investment property to anyone wanting to buy it. You need to use a special “middleman” called a Qualified Intermediary (“QI”) or Accommodator who is required to hold the sale proceeds for you and who then uses those proceeds to buy any replacement property that you want.*
3. **My attorney can handle the exchange for me as my Qualified Intermediary. Or, my accountant knows all my tax stuff – I’m going to use my CPA as my QI.** *No! If the seller’s attorney or accountant has provided any legal or accounting related services (or any service not exchange-related) in the two-year period before the exchange, they are disqualified and may not act as the Qualified Intermediary.*
4. **To do a 1031 exchange I just need to file a form with the IRS with my tax return and “roll over” the proceeds into a new investment. As long as the seller doesn’t touch the sales proceeds, he can do an exchange any time.** *No! A valid exchange requires much more than just reporting the transaction on Form 8824. One of the biggest “no-no’s” in structuring an exchange is allowing the taxpayer to have actual or constructive receipt of the sale proceeds. This could trigger a taxable event. The QI must hold the sale proceeds during the course of the exchange. There are specific deadlines that must be adhered to as well. You have 45 calendar days, starting from the date you close on your sale, to simply identify the possible replacement properties you might want to buy. Then you have 180 days (again, starting from the day you close on the sale) to close on the purchase of one or more of the properties identified.*

5. **The capital gain tax rate is only 15%. I'll just bite the bullet and pay the taxes now.** *Think twice about that!* Capital gain tax rates have changed significantly starting in 2013. Your capital gain tax rate might be 15%, or possibly 18.8% or even as high as 23.8% (depending on your income level, and subject to the new 3.8% Medicare surtax). And since you are selling investment property, there is probably the recapture of depreciation. The depreciation recapture tax rate is 25%. A non-exchanger will also have to pay the tax at the state level as well. In most cases, the state tax on the sale of real estate can also be deferred by doing a 1031 exchange. In summary, if you do not exchange and simply pay the tax now, you could have an **effective or blended** capital gains rate as high as 35% to 40% (State tax + depreciation recapture + new capital gains rates).
6. **All of the funds from the sale of the relinquished property must be reinvested.** *Not necessarily!* A taxpayer or exchanger can buy down in value. Or a taxpayer can choose to withhold funds or receive other non-like-kind property in an exchange. But the amount that they buy down, or money they withhold, or any other non-like-kind property received, is considered "boot" which means the exchanger likely will have to pay some taxes.
7. **You must replace the debt that you had on the relinquished property with at least the same amount of debt on the replacement property.** *Not necessarily!* The exchanger can always bring their own cash to the closing table for the replacement property to offset any reduction in debt.
8. **Exchanges are complicated and are only for big investors.** *Again, No! Exchanges don't have to be complicated!* A good Qualified Intermediary will work with you and your tax or legal advisors to make sure the process is done correctly and as seamlessly as possible. And exchanges are not just for big investors: anyone owning investment property that has a gain (the market value greater than its adjusted basis) should consider a 1031 exchange.
9. **When I sell my home – where I live with my spouse and the kids and our pets – I should do a 1031 exchange.** Tax-deferred exchanges are not for real property held for only personal use. 1031 is for investment property only: you cannot 1031 exchange your personal primary residence for another home. There is another part of the tax code that already allows you to sell your home and avoid capital gain tax. *But there are ways to use 1031 to exchange mixed-use rental / vacation homes within certain parameters. Consult your QI and tax advisor for more information.*
10. **If you sell one property, you can only exchange into one property.** *No.* You can sell one property and exchange into multiple replacement properties. And the other way around as well: you could sell multiple properties and exchange into one larger and more easily managed property. You can buy or sell any number of properties in an exchange. The devil is in the details, so choose a good QI to help you.



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