

The Benefits of 1031 Exchanges

In Chapter Two of *The Automatic Millionaire Homeowner*, I mention several reasons why real estate is a good long-term bet. Here, my focus turns to one of those reasons: The 1031 Tax Break for Rental Properties.

Named after the section of the Internal Revenue Code that governs these transactions, 1031 Exchanges permit the deferral of federal capital gains taxes when you sell a rental property and apply all the proceeds to buy another rental property within 180 days. (Not all investment properties qualify, so be sure to check with your tax advisor and review [IRS Publication 544](#).)

Is a 1031 Exchange Right for You?

As a rental property owner, one of the best investment decisions you can make is the 1031 tax-deferred treatment of capital gains. Why? Because it helps you preserve and build wealth. If the sale of your rental property will result in a gain and you plan to purchase another investment property, consider a 1031 Exchange. That way, you essentially receive an interest-free, no-term loan from Uncle Sam.

Taking Advantage of a 1031 Exchange

Contact a Qualified Intermediary

So, you decide to pursue a 1031 Exchange. Your next step is to contact a Qualified Intermediary (a company who acts as the accommodator in the exchange) that legally holds funds to facilitate a 1031 Exchange by entering into a written agreement with you for the exchange of properties.

Note: A Qualified Intermediary must not be a related party to the Exchanger (e.g., agent, attorney, broker). For more information about Qualified Intermediaries, please refer to [IRS Publication 544 \(Sales and Other Dispositions of Assets\)](#).

Timing Is Everything

To complete a 1031 tax-deferred exchange, there are strict timeline requirements to consider.

- **Identification period:** You must identify a suitable replacement property within 45 days of selling your relinquished property. Assessing your replacement property options **before** closing on your relinquished property is a strategic move.
- **Exchange period:** The replacement property's closing must occur within the exchange period, which ends within the **earlier of** 180 days after the date on which you transfer the relinquished property **or** your tax return deadline for the taxable year in which the transfer of relinquished property occurs.

Note: Both the 45- and 180-day rules are very strict and cannot be extended -- even if the 45th and 180th days fall on a Saturday, Sunday or legal holiday.

Tips for a Successful 1031 Exchange

Failing to meet the 1031 Exchange rules does not prevent you from making an investment in a rental property; it just means that the IRS would consider your transaction to be taxable. To qualify for the tax-deferred treatment of capital gains, it is crucial to

- **Seek the advice of your tax advisor prior to identifying your replacement property.**
- **Select a qualifying, like-kind replacement property.**
Apartments, condos, duplexes, commercial property, raw land and rental homes* are examples of like-kind property. According to Internal Revenue Code 1031(a), "like-kind" means similar in nature or character, notwithstanding differences in grade or quality.

* Qualification as a like-kind property depends upon the extent of personal use.

- **Make sure that the replacement property is subject to an equal or greater level of debt than the relinquished property.**

If not meeting this requirement, you must pay taxes on the difference in debt value or add cash funds to offset the replacement property's lower level of debt.

- **Meet the 1031 timelines (45- and 180-day deadlines).**
- **Use a Qualified Intermediary.**
Neither you nor your agent should take possession of the property or proceeds from the sale.

Additional Resources

Useful resources to help you learn more about 1031 Exchanges:

[IRS Publication 544](#) (Sales and Other Dispositions of Assets)

The IRS publication that addresses 1031 Exchanges.

[National Association of Realtors' Field Guide to 1031 Exchanges](#)

A helpful 1031 Exchange resource. (Access to many articles does not require a realtor login.)

Bank Rate www.Bankrate.com

Provides free rate information to consumers on many financial products and includes several articles about 1031 Exchanges.