KICK THE (TAX) CAN DOWN THE ROAD

With 1031 Exchanges

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"OUR NEW CONSTITUTION

is now established and has an appearance that promises permanency; but in this world, nothing can be said to be certain, except death and taxes." - Benjamin Franklin, 1789.

This Benjamin Franklin quote is amazing in that he correctly and amazingly predicts the enduring nature of the Constitution of the young United States (what are the odds that this country would still exist and rise to great heights back then?) but also in that he so perfectly articulates two phenomena that strike fear and anxiety into people's hearts. Death and taxes. Just as with death, there exists no elixir that will permanently stave taxes off. That said, like a healthy diet and exercise, certain parts of the Internal Revenue Code can shoo away the grim reaper of taxing, the Internal Revenue Service.

Most people have at one point or another owned investment real estate or thought about dipping their toes into it. It is a great way to build wealth, diversify your net worth, and do so in largely tax-advantaged means. While real estate has several tax advantages, one that we'll focus on today comes when you are selling your property.

In a very simplified example, let's say you purchased an apartment building for 100,000 in 2010. The market has done well, and it is now worth $1,000,000 and you are considering selling it. The Grim Reaper needs to take his cut. If you were to sell the building, you would pay 20% on your long-term capital gain of $900,000 or $180,000 in taxes. While you have still done well on your investment, the taxes take a serious bite out of your take-home profit. This is where 1031 Exchanges come into play.

What is a 1031 Exchange?

A 1031 Exchange, or a like-kind exchange, allows an investor selling real estate to defer capital gains taxes while investing in a new property. The primary advantage is to allow the investor to invest in a different property while not getting hit with a tax bill.

KEY RULES & REQUIREMENTS

1. Like-Kind Property

Both the property being bought and sold must be an investment property. They don't have to both be the same type of real estate though. You can exchange a duplex for a strip mall for example. However, personal properties are excluded.

2. Timeline

The investor has 45 days from the sale of the property to identify up to three replacement properties. After identifying the properties, the investor has 180 days from the sale of the initial property to close on at least one of the identified properties.

3. Same Taxpayer Rule

The name on the title of all properties must be the same.

4. Reinvestment Requirements

Whatever is reinvested into the new property is tax-deferred, if you keep some of the sale proceeds, that portion (called the boot) is taxable.

5. Qualified Intermediary

The process must be executed by a QI or an exchange facilitator. The investor cannot touch the proceeds between the sale of the old property and the purchase of the new one.

POTENTIAL BENEFITS OF A 1031 EXCHANGE

Tax Deferral. This is the primary advantage of a 1031 exchange. If combined with other estate and tax planning techniques (like a step up in basis), the tax can be deferred or eliminated.

Wealth Growth. Because the 1031 exchange provides flexibility in finding better investment prospects without paying taxes, investors can grow their wealth in meaningful ways.

POTENTIAL DRAWBACKS OF A 1031 EXCHANGE

The single greatest drawback of a 1031 exchange is that it is a nuanced and complex tax strategy. As with many things IRS, there are no exceptions or takebacks. One mistake and you will be saddled with the very thing you hoped to avoid: a big tax bill.

While 1031s are great, I do think they fail to address a common concern I hear:
"This real estate has been a wonderful investment but I'm ready to sell as I'm seeking less work and diversification...but I don't want to pay taxes."

This issue is addressed by a nuanced part of the tax code known as **Delaware Statutory Trusts or 1031 DSTs**.

A 1031 DST is a legal structure that allows for the tax deferral and exchange of a real estate investment like the 1031 described above but instead of buying another property, you exchange for a share of a real estate trust. Put differently, you can sell your 100% stake in your duplex in exchange for a 1% stake in a diversified commercial real estate portfolio.

The primary advantages of electing to use a DST instead of buying another property outright are as follows:

Diversification: DSTs provide an opportunity for investors to diversify their real estate holdings without the burdens of direct property management. By investing in a DST, individuals can gain exposure to a variety of properties and markets, reducing the risks associated with concentrating investments in a single property.

Scaled Property Management: DSTs are professionally managed and not much different from owning a REIT. With your shares, you get access to institutional real estate portfolios without any of the work.

Passive Income: Investors in DSTs receive a share of the rental income generated by the properties held within the trust. This income can provide a reliable stream of passive cash flow.

THE DRAWBACKS OF DST

Loss of Control: While professional management is an advantage, it also means that investors have limited control over property decisions. Major decisions are typically made by the trustee or sponsor of the DST.

Illiquidity and Investment Risk: Like many real estate investments, DSTs can be illiquid. Once invested, it may be challenging to liquidate your position quickly if needed. Additionally, you have exposure to the ups and downs of the real estate market.

Tax Implications Upon Exit: While DSTs offer tax deferral benefits during the holding period, investors need to be aware that eventually selling the DST interests might trigger capital gains taxes unless they engage in another 1031 exchange.

1031 DSTs offer a compelling strategy for real estate investors seeking to defer capital gains taxes, diversify their holdings, and enjoy passive income from professionally managed properties. These investment vehicles can be particularly advantageous for individuals looking to exit highly appreciated properties and reinvest in a more diversified portfolio. However, investors must carefully consider their financial goals, risk tolerance, and the specific terms of the DST before making investment decisions. Consulting with financial advisors and tax professionals is essential to ensure that DSTs align with an investor's overall financial strategy and objectives.

QUESTIONS?

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