Making the 1031 Exchange: Is Swap Till You Drop Always the Best Motto?

Holding property for too long is a mistake many investors make. On the other hand, rushing to buy a property to comply with 1031 rules can be a bigger problem. Sometimes it's better to take the tax bite than rush into a bad deal.

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Investors are keen to the fact that real estate generates diverse investment benefits. At the same time, it requires oversight and hard work. Income is the first benefit that comes to mind, but equally valuable are the tax-shielding benefits it offers, such as depreciation and expense deductions, capital returns at a refinance, or deferring capital gains via a 1031 exchange.

As an investor, you should be prudent to evaluate all costs and benefits a piece of real estate provides, with the goal of maximizing total returns, while minimizing risk and headaches. When you focus only on some components of investment real estate, you can miss the bigger picture — and bigger opportunities.

For example, owning a rental home until you've paid off the mortgage may seem ideal when you're receiving steady rental income from tenants. But this strategy may prevent you from taking advantage of other profitable opportunities. What if instead you refinanced, purchased a second property to multiply returns from two assets, and sell or exchange that property for something that better meets your financial and lifestyle goals?

Many investors hold property for far too long because they're overwhelmed by the sale or exchange process. But holding onto the property too long puts you at risk if your financial circumstances change and you're not able to properly manage and maintain the investment. Even if your finances don't change, holding onto the property puts you at risk if the property value becomes static or the depreciation can no longer be maximized.

Should You Reinvest by Utilizing a 1031 Exchange?

If you want to move away from day-to-day, hands-on property management, or want to leverage tax benefits of greater depreciation, higher tax-deductible expenses, or are looking for a better asset in a more desirable market, then it's time to consider the benefits of a 1031 exchange. The 1031 exchange allows equity from one real estate investment to roll into another, while deferring capital gains taxes. And it's often one of the best methods for building wealth over time.

As a quick overview, the 1031 exchange can accurately be considered a "rollover," as sale proceeds from a sold property are rolled over into a purchased property to postpone capital gains tax. The purchased property is often referred to as a “replacement,” and generally meets exchange requirements if it is (1) like-kind investment real estate titled in the same manner as the sold property; (2) identified within 45 days and purchased within 180 days of closing the sold property; (3) of equal or greater value than the sold property and purchased using all proceeds from the sold property; and (4) purchased through a third-party exchange facilitator.

Recently, I worked with an investor who sold a 16-unit multifamily building that he had owned for 30 years. At the time of sale, the property was free and clear. Every few years — over three decades — he contemplated selling the property but was afraid of the 1031 exchange process. If he *had* exchanged and rolled his equity a few times, his equity today would likely be worth $4 million instead of $2 million.

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Tax Benefits Come with Strings Attached

The motivation to use a 1031 exchange can be substantial. This is because investor capital that otherwise would be paid as capital gains tax is rolled over as part of the down payment into a replacement property. This provides greater investment benefits than the sold property.

Many investors buy real estate in a 1031 to defer taxes, but given the time pressure they frequently purchase a property they don’t necessarily want. For example, you may not have the time to complete thorough market research, so you may succumb to pressure and impulsively buy a bad investment just to avoid paying the taxes. Buying a bad piece of real estate, either because of its location, market or poor fit for your lifestyle, could cost more than the capital gains taxes in the first place.

An example of poor exchange planning could go something like this: With $500,000 in proceeds from your sale, you choose to exchange and defer $150,000 in taxes. Your last option for a replacement property is a strip mall center with low-quality tenants in a market that is declining. You could potentially lose more than $150,000 re-tenanting or making costly building renovations. In the end, you’d have been better off paying the required taxes while taking the time to do your homework and more wisely invest the $350,000.

The Bottom Line

No one can predict with absolute certainty how a 1031 investment will shake out, but doing the obvious homework on regional market metrics, and solid due diligence on the building itself, may help you avoid a costly investment.

If you do decide to swap till you drop, start talking to brokers and sponsors of real estate investments the second you make the decision to sell. A good broker can help you cast a wider net to find a better product. Sponsors generally have institutional-grade properties and frequently structure acquisitions to qualify for 1031 treatment.