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Section 1031 Tax-Deferred Exchanges: Swap Till You Drop

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INTRO TO SECTION 1031.

Section 1031 of the Internal Revenue Code permits the deferral of taxable gain on sale of investment or business property. To qualify, taxpayers must satisfy a number of technical requirements. Section 1031 is a “golden oldie” that was first adopted in 1921 but recently has been under attack in connection with broader tax reform proposals discussed below.

DEFERRAL NOT EXCLUSION.

Section 1031 defers the gain that otherwise would be recognized in a taxable sale. This is deferral not exclusion; the gain that otherwise would be recognized in a taxable sale is deferred until the replacement property is transferred in a taxable sale.

MANY REAL ESTATE INVESTORS “SWAP TILL THEY DROP”.

While Section 1031 only defers the gain, savvy taxpayers do not sell their replacement property, they exchange it, and continue the deferral by exchanging over and over. In this way, many taxpayers enter into a series of exchanges, completed over many decades, sometimes called “swap till you drop”. This has proven to be a valuable strategy for building real estate wealth over a lifetime.

LIKE KIND STANDARD – NO PROBLEM.

To qualify for Section 1031 treatment, the replacement property must be of “like kind” to the relinquished property. This requirement has not been much of a hurdle to exchangers because most classes of real estate are like kind. Thus, it is permissible to exchange unimproved real estate (land) for improved real estate (office building, shopping center, apartment community, etc.). Also, one type of improved real estate (for example, an apartment community) may be exchanged for another type of improved real estate (for example, a medical office building).

EXCHANGES ARE DRIVING REAL ESTATE SALES NATIONWIDE.

Exchanges are driving real estate sales across the nation, especially at the lower end of the market. Many smaller 1031 exchangers, who have less than \$1 million to reinvest, are seeking net leased properties,

typically pharmacies and retail properties. This has driven cap rates down into record territory, first for investment grade properties such as Walgreens and CVS pharmacies, and, then, for non-investment grade, net leased properties. Also, several mega transactions, including Hilton Worldwide Holdings, Inc. and Taubman Centers, have driven the demand for larger investment grade properties. The upshot – desirable net leased properties are trading at record 6 cap rates, with properties being listed in the 5's!

DELAWARE STATUTORY TRUST (DST) ALTERNATIVE.

A growing number of smaller exchangers are acquiring an alternative to a “whole” replacement property by investing in a Delaware Statutory Trust or DST. In a DST, a sponsor firm acquires a larger, typically investment-grade, property and sells DST interests in that property to investors as 1031 replacement property. A properly structured DST qualifies as like kind replacement property under published IRS guidance. DSTs also solve a number of challenges encountered by many smaller investors who may struggle to find replacement property and comply with a number of technical rules, such as the requirement to identify and close on all replacement property within the statutory time periods. (The identification rule will be the topic of a future column.)

TAX REFORM.

Section 1031 has survived for over 90 years. However, the Obama administration and certain legislators seek to raise revenue for other tax proposals by limiting Section 1031. Section 1031 serves a vital role in a vibrant real estate economy. In addition, Section 1031 generates substantial revenue, albeit indirectly. Replacement property has a “carry over” tax basis; this results in lower depreciation deductions and higher ordinary income to taxpayers from rental income. Also, substantial taxable income is generated by service providers who participate in exchange transactions (lawyers, accountants, accommodators, title agents, title companies, escrow agents, etc.). Please join the Federation of Exchange Accommodators’ campaign to preserve Section 1031 by completing the [linked voter voice](#), which will be sent to Congress. Every vote is important.

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