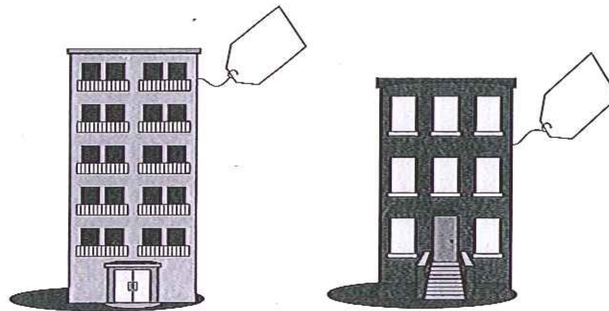
Trade Show Speaker

How to Avoid the Most Common Mistakes in a 1031 Exchange

by Charlie Kennedy



With the apartment market experiencing tremendous velocity, many properties are trading hands. As a result, a number of our clients have called with questions about the 1031 Exchange process. Unfortunately, some of those clients received proper information too late and experienced some negative circumstances with the sale of their property. With complete and correct information, most mistakes can be easily avoided. In an effort to make your experience with 1031 Exchange more predictable and rewarding, we would like to share our knowledge and strategies for avoiding the most common mistakes of the 1031 Exchange.

Before we review some of the pitfalls of a 1031 Exchange it is important to clarify that the 1031 Exchange is designed to defer capital gains taxes, not to eliminate them altogether. Most people recognize tax deferral as a good strategy. As long as investors continue to "trade up" they are acquiring larger assets and potentially more net spendable income. While there are many reasons a 1031 Exchange is a step in the right direction, we find that many property owners make mistakes caused by "fear"—fear that once the old property is sold, owners won't be able to find a replacement property in their price range and/or in the time required to fulfill the 1031 requirements.

Avoid Pitfall #1: Do not purchase another property before you sell the old one.
This might surprise you, but we actually received a number of calls this year from people who have purchased a replacement property prior to selling their existing one with the intention of conducting a 1031 Exchange. You may be wondering why they did this? The answer is fear. Fear, they wouldn't find a replacement in time so they bought one before the old property was sold. Sounds logical right? Unfortunately, that action is not in accordance with the IRS code. Our clients then wanted us to somehow unwind the transaction once their property was sold, and put it back together again. This just does not work. In order to enjoy the benefits of a 1031 Exchange, the investor needs to sell the first property prior to purchasing the second property. Since the proceeds from the first property will usually be used to acquire the second property, this doesn't come up often, but when it does it creates a problem that can not be resolved.

"In order to enjoy the benefits of a 1031 Exchange, the investor needs to sell the first property prior to purchasing the second property."

Avoid Pitfall #2: Do not put the proceeds of selling the primary property in your bank account
On occasion, we receive calls when the client says, "I've just sold my property and now I want to start the 1031 process." After some discussion we learn that the seller has held on to the proceeds from the sale. This is another violation of the IRS code. To benefit from 1031 Exchange tax shelters, the investor cannot have control of any of the proceeds received from the sale of the primary property. By law, all money must be held by a Qualified Intermediary (also referred to as an Accommodator). Associates, employees, attorneys, brokers and CPAs are also disqualified from holding proceeds, nor can the funds be left in escrow.

How to Avoid the Most Common Mistakes in a 1031 Exchange

Avoid Pitfall #3: Hold 'em for at Least One Year

To qualify for a 1031 Exchange, property must be held for at least a year plus one day. With the rapid appreciation Southern California has experienced in the last three years a number of people want to capitalize on this as soon as possible. This mistake can usually be avoided if you are using a good broker. When the property is listed we always ask how long the property has been owned. If for some reason an owner lists a property that has been owned for less than one year and then goes under contract with a buyer, they could find themselves in a delicate situation.

Avoid Pitfall #4: Understand the 1031 Exchange timeline

Even though timelines have remained constant, they always produce many questions. The following is a list of some important time frames:

- The investor has 45 days from the date of closing on the primary property to identify a list of 3 properties, one of which must be purchased as the replacement property.

- From the date of closing, the investor has 180 days to close on one or more properties from the list submitted at the 45-day mark. For example: if you identified three properties on the 45th day, and then took 20 days to conduct due diligence on all three properties and selected the one you liked best, you would then have 115 days remaining to close the transaction.

- CAUTION: If the exchanger is selling two properties in order to buy one larger replacement property, then the timing begins when the first relinquished property closes. The replacement property must be identified for BOTH relinquished properties within 45 days of the first relinquished property closing escrow, whether or not the second relinquished property is even sold.

While it seems complicated, all of these mistakes can be easily avoided by working with a competent broker. A good broker will know the guidelines and be well acquainted with a Qualified Intermediary.

Surprisingly enough more and more of our clients are simply cashing out. They say, "If you can really get me this price I'll sell and pay the taxes. I never thought it would be worth that much." To better understand your capital gains you can go to www.healstone.com and click on the Capital Gains Tax Calculator.

With the right tools, your Exchange experience can exceed your expectations.