CPA
Practice Advisor

well as help the investor diversify their portfolio.

Nov. 13, 2023

By Daniel Goodwin, AWMA, Kiplinger Consumer News Service (TNS)

It's a tale as old as time among real estate investors. Even after dotting all the i's and crossing all the t's and adhering to the multiple requirements of a 1031 exchange, more than one transaction has nevertheless been tripped up at the finish line by the belated discovery of a mortgage or other form of debt on the replacement property.

Value of a 1031 exchange

But only if all the rules are followed.

If Section 1031 of the IRC is not properly followed, the tax benefits associated with it may be jeopardized, and the whole transaction may become subject to capital gains taxes. Therefore, it is essential to engage the services of a qualified intermediary, as they are not only recommended but required by law. These experts are responsible for guaranteeing that every aspect of the transaction adheres to the code's standards.

Real estate investors and their intermediaries are likely well-acquainted with the various requirements involved in these transactions. These typically involve utilizing a third party to handle the funds, identifying replacement properties within 45 days of selling the relinquished property and completing both sides of the transaction within 180 days.

In certain situations, an investor may not find the complete debt situation of a replacement property even after conducting meticulous research. This may cause a sudden scramble at the end of the process to factor in both the equity and debt. Regrettably, it is not possible to extend the closing deadline of 180 days.

Here's an example

Suppose an investor sells a property worth $1.4 million, which includes a mortgage worth $400,000. To satisfy the IRS requirements, the replacement property must meet two criteria. First, it must be valued at $1.4 million or more, and second, it should account for the $400,000 debt from the previous property. To fulfill this requirement, most investors have historically opted for obtaining a new loan of $400,000 or more instead of utilizing their personal funds to cover the debt.

Of course, that was a lot easier to pull off during the decade that the Federal

Delaware statutory trust

In the face of these changing realities, many investors are turning to another viable solution: exchanging the debt with an investment in a Delaware statutory trust (DST). By opting for this approach, not only will the requirement for debt replacement be met, but it will also give the investor the opportunity to improve the caliber and variety of their investment portfolio.

DSTs are similar in structure to real estate investment trusts (REITs), enabling investors to obtain a fractional ownership interest in institutional-quality assets that may be challenging to acquire otherwise. These assets can be located in different geographic regions and asset classes, allowing investors to diversify their portfolios and gain quality assets. Passive investors may find it worth their while to consider investing in a DST, given these advantages.

Like-kind exchange

The icing on the cake for investors taking part in a 1031 exchange is a revenue ruling issued by the IRS in 2004 that clarified that the IRS considers a DST to be a like-kind exchange, fulfilling the primary requirement of eligibility for a 1031 exchange. Since that decision, DST investments have been used by investors for part or all of either the equity or debt in an exchange.

Deferring capital gains

In our example above, the investor goes from an intractable dilemma to a position of power, not only being able to successfully close the 1031 exchange of their choice and obtaining the replacement property they had their eye on, but also strengthening their real estate portfolio with institutional-quality assets that would otherwise have been impossible to obtain—all without weakening their financial position by a

relinquished property that was sold for equal to or less than $400,000.

The DST investor would also be spared the process of securing financing on their own, as the investor would have access to the existing terms secured by the DST sponsor, who is presumably in a better position to secure more favorable terms than most individual investors not named Buffett. The DST's structure also shields the individual investor from personal liability beyond the amount of their investment in the DST; this limited liability is an additional attractive feature of the investment.

With the proper structuring of the exchange, it's possible for an investor to meet their debt replacement obligation by partially investing in a DST and then using the remainder of their investment capital for a direct purchase of an investment property. The key is to properly identify replacement properties in a timely fashion and then structure the purchase of those properties to fully address the requirements of a like-kind exchange.

Tax benefits like those available in a 1031 exchange are hard to come by and can be even harder to execute. It's critical to work with a qualified intermediary who not only understands 1031 exchanges, but DSTs as well, to fully realize the bountiful benefits of a properly executed exchange.

Daniel C. Goodwin, Provident Wealth Advisors and AAG Capital Inc. are not attorneys and do not provide legal advice. Nothing in this article should be construed as legal or tax advice. An investor would always be advised to seek competent legal and tax counsel for his or her own unique situation and state-specific laws.

ABOUT THE AUTHOR:

Daniel Goodwin is the chief investment strategist at Provident Wealth Advisors, a registered investment advisory firm in The Woodlands, TX.

(NASBA) as a sponsor of continuing professional education on the National Registry of CPE Sponsors.