How Do I Complete a 1031 Exchange?

Also called a like-kind exchange, it allows an investment-property seller to postpone taxes by reinvesting in similar property – but an exchange has very specific rules.

So, you inherited a Walgreens, sold it, made some money and are now looking to save on your taxes. What do you do?

Well, the federal government has a rule in place that can help. It's called a 1031 exchange and is named for a section of the IRS code that "allows you to postpone paying tax on the gain if you reinvest the proceeds in similar property as part of a qualifying like-kind exchange."

While the full legal and the tax implications need to be discussed with a lawyer or an accountant, Ron Schultz, executive vice president at Colliers in Tampa, says a 1031 exchange is a pretty valuable investment tool that, if worked properly, can help property owners keep profits flowing.

"I've been doing it for 20 years and have had legacy clients over decades that have been doing it all their life for the purpose taking advantage of what's in front of them as far as protection from taxation gains," says Schultz.

Schultz uses an inherited or bought Walgreens as an example to show how a 1031 exchange works. You, he says, got the property for $2 million and over time the property has gone up in value from appreciation, and income has increased as rents have gone up. Two years pass and the property is now worth $3 million. You want to cash in, but you don't want to get taxed on that $1 million. A 1031 exchange is probably the right way to go.

You'll reinvest your money, avoid some taxes and keep the investments flowing.

But to pull off an exchange, there is a strict timeline and rules that need to be followed. Once the property is sold, the clock starts ticking and you need to find a replacement, like-kind property. Since it was Walgreens you sold, you need to find another retail property. Schultz is careful not to give anything remotely sounding to, or feeling like, legal or tax advice, so here, in its own words, is what the IRS says needs to happen:

The first limit is you have 45 days from the date you sell the relinquished property to identify potential replacement properties. The identification must be in writing, signed by you and delivered to a person involved in the exchange like the seller of the replacement property or the qualified intermediary. However, notice to your attorney, real estate agent, accountant or similar persons acting as your agent is not sufficient. Replacement properties must be clearly described in the written identification. In the case of real estate, this means a legal description, street address or distinguishable name. Follow the IRS guidelines for the maximum number and value of properties that can be identified.

The second limit is the replacement property must be received and the exchange completed no later than 180 days after the sale of the exchanged property or the due date (with extensions) of the income tax return for the tax year in which the relinquished property was sold, whichever is earlier.

The replacement property received must be substantially the same as property identified within the 45-day limit described above.

1031 investors, Schultz says, are among the most aggressive in the market, taking deals that institutional, publicly traded REITs and individual "mom and pop" investors stay away from because cap rates are often too low. Those more traditional types of buyers are unlikely to touch a deal with only a 5% return. They are looking for higher cap rates, better returns. But a 1031 exchange buyer is interested.

The sweet spot for 1031 exchange buyers is properties between $3 million and $10 million, Schulz says. That's a price range where there are a lot of available options, small restaurants, auto parts stores, Panera and Starbucks locations and similar properties.

Unlike other investors, 1031 exchange buyers are willing to take on those deals the others may pass up because not paying on the gains from the property just sold allows them to be more assertive in the market and, because of the time limits, quicker to make a decision and close on a deal.