

Top 1031 Exchange Misconceptions



Popular Misconceptions About 1031 Exchanges in 2022

1031 Insight July 2022

For 2022, here are our latest top misconceptions we've found that the public has about 1031 Exchanges.

1. Vacation and Second Homes Qualify

I can sell my investment property and use a 1031 Exchange to buy my dream vacation or second home. **MAYBE**

You can sell your investment real estate and reinvest the gain, tax deferred, to purchase a qualifying property. The challenge is making sure it will qualify as 1031 investment property. During the initial 24 months of ownership there are strict rules to follow regarding personal use. The important rule is that you can only use the property for 14 days each year or 10% of the actual days that you rent it out. For example, if you rent it out for 200 days each year, your personal use can be up to 20 days. If you are able to abide by these rules, after two years the dream vacation or second home is yours to use as often as you like without any more requirements. Check with your tax advisor and click on the links below when considering a vacation home or second home as a new Replacement Property to complete your 1031 Exchange. Helpful Links: [Do Vacation and Second Homes Qualify?](#) and [How to Buy Your Vacation Home with a 1031 Exchange](#) and [Strategically Buying Your Dream Vacation Home with a 1031 Exchange](#)

2. The Term Like-Kind

The "like-kind" requirement means I have to exchange the same exact type of property. For example, an apartment building for another apartment building. **FALSE**

The "like-kind" requirement does not mean selling and buying the same exact type of property. In a 1031 Exchange, you can exchange real property for virtually any other real property in the US, as long as the property is held for productive use in a trade or business or for investment purposes. The term "like-kind" refers to the nature or character of the property, not its grade or quality. For this reason, nearly all real property is like-kind to all real property. You can sell a rental house and buy apartments, commercial, industrial, mini storage, bare land, agricultural, etc. Helpful Link: [See what is qualified like-kind property?](#)

3. Net Sales Proceeds

My Net Sales Proceeds is the exact price my Relinquished Property (RLQ) sold for. **FALSE**

Your Net Sales Proceeds is what your RLQ sold for (the contract sale price) minus any closing costs and commissions such as sales costs, sales commissions, attorney/escrow/title/recording fees and your exchange fee. The Net Sales Proceeds is the amount to use that must be met into your new Replacement Property (RPL) if you are seeking full tax deferral with your 1031 Exchange. Helpful Link: [The Tax Deferred Exchange](#)

4. Reinvesting Proceeds

I only have to reinvest the profits (gain) from the sale of my Relinquished Property (RLQ) to fully defer my taxes in a 1031 Exchange. **FALSE**

To have a full tax deferral, you need to reinvest the entire amount of equity from the RLQ you sell into your new investment property. You also need to buy equal or greater in value compared to the property you sold, AND replace the value of the debt that you had on your old RLQ investment property. If you purchase property lower in value or take a portion of the cash from the closing of the sale and only invest a portion of your proceeds towards a 1031 Exchange, you will have a partially tax deferred transaction rather than deferring all of your taxes. This is commonly referred to as boot and you will pay taxes on those funds not reinvested. Helpful Links: [Partial 1031 Exchange](#) and [Boot in a 1031 Exchange](#)

5. Replacing Debt

I must have equal or greater debt on my Replacement Property (RPL) I am purchasing. **FALSE**

On your new RPL, you do need to replace the VALUE of the debt paid off on the Relinquished Property (RLQ), however, the debt does not have to be replaced with debt. The exchanger can always bring their own cash (from outside of the 1031 Exchange) to the closing table for the RPL to offset any reduction in debt, or use other options such as seller financing where the seller of the RPL finances the purchase using a carryback note, use private money, or get another loan from a lender. However, if you are getting a loan, you want to avoid the loan overfunding at closing to result in a boot situation. Very often, at close of escrow the loan value will be figured in and then the QI funds requested. If this leaves any proceeds in the account, this will result in a boot situation because now the taxpayer has cash in hand. Make sure you are working with your tax advisor to assure this does not happen to you. Helpful Link: [Replacing Debt in a 1031 Exchange](#)

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6. Equal or Greater Value Replacement Property

The overall price of my Replacement Property (RPL) doesn't really matter. **FALSE**

In addition to replacing value of debt and rolling over all equity, to have full tax deferral you also need to purchase RPL at equal or greater VALUE to the one being sold. This means looking at the price of the Relinquished Property you're selling (figure out your net sales proceeds) and the price of the RPL you're buying. Buy equal or greater than. Talk to your tax advisor to confirm the exact amount to avoid a tax consequence. *Helpful Link:* [The Tax Deferred Exchange](#)

7. Replacement Property Improvements

I've already purchased my new Replacement Property (RPL) and now want to use exchange funds to make improvements to the RPL to increase its value for this 1031 Exchange. **FALSE**

Making improvements to a RPL is a great way to raise its value, however you cannot do this through a Delayed 1031 Exchange. If you would like to build on or make improvements to a RPL, you need to plan ahead. You can use exchange proceeds by structuring an Improvement Exchange, also known as a Build-to-Suit Exchange or a Construction Exchange. IPX1031, through a separate entity, takes title to the property while the improvements are made and then transfers the improved property to you. This structure adds much more complexity and cost to your exchange.

Helpful Links: [Improvement Exchanges](#) and [Reverse & Improvement Brochure](#)

8. Related Parties

I can purchase my Replacement Property (RPL) from someone in my family. For example, my brother. **DEPENDS**

Buying the RPL from a person or entity classified as a "Related Party" requires careful consideration and may not be permitted. The Exchanger must follow specific rules for the exchange to qualify for tax deferral and there may be a 2-year holding period. Read more details below. *Helpful Link:* [Related Party Exchanges](#)

9. Last Minute Reverse Exchange

I found the perfect property and it's going to sell fast. I'll do a quick Reverse Exchange and buy that Replacement Property (RPL) now, then sell my old Relinquished Property (RLQ). **FALSE**

The concept of buying first/selling second is correct, but Reverse Exchanges are not quick or simple to set up. Reverse Exchanges require extra time to structure. In a Reverse Exchange, you cannot own your RPL and RLQ at the same time. IPX1031 (through an affiliated entity) needs to be the title holder of the old RLQ or new RPL. Due to this requirement, Reverse Exchanges take longer to set up. And because there is increased complexity and more steps involved, there are additional costs and fees than a typical Delayed Exchange. *Helpful Links:* [Reverse Exchanges](#) and [Key Steps to Ensure a Successful Reverse Exchange](#) and [Reverse & Improvement Brochure](#) and [How to Initiate a Reverse Exchange](#)

10. Vesting

I need to hold legal title for the new Replacement Property (RPL) in the same exact name or entity as I held the old Relinquished Property (RLQ). **FALSE**

This is not always the case. Vesting needs to be the same TAXPAYER. For an exchange to satisfy IRC §1031, the taxpayer that will hold the title to the Replacement Property must be the same taxpayer that held title to the Relinquished Property. To illustrate, you can sell the RLQ property in your revocable trust and buy the RPL in your name because you are the same taxpayer. However you cannot sell as a partnership and buy as individuals; those are not the same taxpaying entities.

Helpful Link: [Vesting Issues](#)

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At IPX1031, we pride ourselves on being the industry leader in 1031 expertise, service and security. We aim to be your complete information resource and look forward to helping you and/or your clients maximize qualifying investments through a 1031 Exchange strategy. For more information about 1031 Exchanges, our company, our complimentary 1031 Exchange webinars, or to [initiate an exchange](#), visit our website at www.ipx1031.com or email or call today.

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