



7 MISCONCEPTIONS

about 1031 EXCHANGES

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1. TO DEFER ALL INCOME TAXES IN AN EXCHANGE, YOU ONLY NEED TO REINVEST THE NET CASH FROM YOUR SALE

- **THE TRUTH IS** that in order to defer all income taxes in a 1031 exchange, you must trade equal or up in value and in equity. This rule makes it difficult to de-leverage and 1031 exchange; then again, most real estate investors consider leverage a useful tool.

2. TAX BASIS RESETS TO THE PURCHASE PRICE OF THE REPLACEMENT PROPERTY IN AN EXCHANGE

- **THE TRUTH IS** the tax basis does not reset to the purchase price of the replacement property.
- To find the basis, use the following formula:
 - Find the tax basis of the relinquished property.
 - Add the amount by which the value of the replacement property exceeds in value of the relinquished property.

3. AN INVESTMENT PROPERTY IS CONVERTED INTO A PRIMARY RESIDENCE, AND THEN IT IS LIVED IN FOR TWO YEARS; THE PROPERTY CAN THEN BE SOLD TAX-EXEMPT UNDER IRC SECTION 121

- **THE TRUTH IS** to assure the 1031 tax deferral, you must not convert your replacement property to your principal residence for at least two years. Afterward, if you do convert to the principal residence and IRC Section 121 applies, then the depreciation will always be re-captured in full. Long-term capital gains will be prorated on how long the property was held for investment used as a principal residence.
- No matter how long you own and occupy the property, you will always have to pay tax on the recaptured depreciation and a prorated portion of the long-term capital gain.

4. VACATION HOMES ARE 1031 EXCHANGE ELIGIBLE

- **THE TRUTH IS** that vacation homes only qualify for a 1031 exchange if the taxpayer only uses the property for the lesser of 14 days or 10% of the days rented, whichever is less, per year.
 - Days spent by the taxpayer performing maintenance and repairs do not count against the taxpayer.

5. REAL ESTATE MUST BE USED SIMILARLY TO BE CONSIDERED LIKE-KIND

- **THE TRUTH IS** pretty much all real property is like-kind to all other real property. However, all 1031 exchange properties must be held for investment or used in trade or business. This is known as the "qualified use test". The IRS will usually look to applicable State law to define real estate usage.

6. I MUST TRADE EQUAL OR UP IN DEBT TO FULLY DEFER INCOME TAX IN A 1031 EXCHANGE

- **THE TRUTH IS** this is not technically true. You must trade equal or up in value *and in equity*; you may replace debt with new cash.

7. IF I TAKE CASH OUT FROM THE EXCHANGE SALE, THEN I CANNOT EXCHANGE THE REMAINDER

- **THE TRUTH IS** it is perfectly fine to take cash out of the 1031 exchange sale. You will pay tax on the full amount of the cash taken out, but the balance can still be exchanged.
- Since the borrowed money is not income, it is sometimes permissible to take out tax-free cash out of a 1031 transaction via a cash-out refinance of either the relinquished or replacement property.