

1031 Exchange Rules To Defer Your Real Estate Capital Gains Tax

Conducting a 1031 Exchange is a great way to defer tax liability on a sale of an investment property. I was strongly considering doing a 1031 Exchange after **selling my San Francisco rental house** in 2017 for \$2,740,000 because I had bought it for only \$1,520,000 in 2005. This post will go through the 1031 exchange rules so you can save on taxes.

After much consideration, as you will learn in this post, I decided not to do a 1031 Exchange because the tax savings/deferment benefits did not outweigh my desire for:

1. Reducing investment risk exposure given the SF real estate market rose over 60% since 2012
2. Simplifying life as a new father to a baby boy
3. Reducing the amount of property taxes I wanted to pay each year e.g. <\$50,0000
4. Moving to Hawaii in several years

Here are the key rules every real estate investor must follow if they want to do a 1031 Exchange. As you will read, it's not a slam dunk.

1031 Exchange Rules To Follow

Before you do a 1031 Exchange, here are the rules. The main rule that tripped me up was the time I had to find another property to do a 1031 Exchange.

#1: Like-Kind Property



An example of a like-kind property is if you sell a single family rental, then you need to acquire another single family rental. The same goes for selling a multi-unit property. You must turn around and acquire a multi-unit property.

#2: No Primary Residence, Only Investment Or Business Property

The property must be a rental property or business property, and not a primary residence.

Originally, I wanted to sell my San Francisco rental house and use the proceeds to do a 1031 Exchange to buy a sweet \$3.2M primary residence in Honolulu in order to live closer to my parents and live a more relaxed pace of life.

But I could only buy a \$2.74M+ rental house in Honolulu and rent it out for at least one year before making it a primary residence. I didn't want to deal with the headache of managing property, so I passed.

#3: New Property Must Be Equal Or Greater Value

Selling my SF rental house for \$2.74M is a lot of money. With rents slowing and the economy at the tail end of a long bull run, I didn't want to have to buy another property worth at least \$2.74M. \$2.74M goes a much longer way in every part of the country except for Manhattan. Even in Honolulu, \$2.74M gets you a house at least twice as large.

If you want to **reduce investment risk exposure**, doing a 1031 Exchange is not the solution.

#4: You Will Pay Taxes On Overage

In my example, let's say I sold my SF rental house for \$2.74M and turned around and bought a Honolulu rental house for only \$1.74M. The overage is \$1,000,000 and is taxable. The difference is called "boot." Further, you can't double dip and use the \$250K/\$500K tax free provision plus the 1031 Exchange. You've got to pick either or.

Related: [**How Much Does It Cost To Sell A House**](#)

#5: Must Be The Same Tax Payer

There must be consistency on the tax return where the seller's name is the same as the 1031 Exchange buyer's name. The consistency is to prevent people from transferring assets and avoiding paying taxes. Based on the new tax rules, the estate tax kicks in at \$11.7M for individuals and \$23.4M for married couples.

#6: ID Up To Three Properties Within 45 Days

Upon closing, you have a tight 45 days to identify up to three properties for 1031 Exchange. Therefore, you need to start looking for properties before you even put your investment property on the market for sale.

I put my property up for rent or for sale (ran a race between myself to rent out the house and my realtor) around May 1, and I immediately searched online for all the property I could buy for \$2.74M – \$3.5M in Honolulu's Kahala district. I then flew out to visit them and got my parents to visit them and report back as well. My house didn't close until 45 days later, so I really had more like 90 days to find three replacement properties.

But I decided about one week before closing (38 days in), that I couldn't comfortably identify three properties that I wanted to live in. Further, I wasn't 100% sure of moving back to Honolulu then. Following the 1031 exchange rules can be difficult with such a small window of time.

#7: You've Got To Actually Buy A Property Within 180 Days

Since I sold my house in mid-June, I would have to purchase a new property by mid-January. With a new baby boy to take care of, we felt this was way too rushed. To have a \$2.74M+ rental property in Honolulu to manage from 2,500 miles away felt like a lot of work and the same amount of stress. If there was a tsunami or an economic downturn, we wouldn't be able to sleep well at night.

Related: [**Reasons Not To Do A 1031 Exchange To Save On Taxes**](#)

A 1031 Exchange Is A Wise Move IF You Can Find The Right Property

The biggest advantages of a 1031 exchange is that you can avoid having to pay capital gains taxes on the sale of an investment property. This can be a huge benefit for real estate investors who know which markets are primed to grow next. In my opinion, [heartland real estate](#) is the most promising due to high cap rates and low valuations.

Be careful not to conduct a 1031 exchange if you can't find the right property. To save on taxes while investing in a depreciating asset is a big no-no. Also be care about the reduced basis for depreciation on the replacement property. Do not let the tail wag the dog!

One of the best real estate investment rules to follow is [BURL: Buy Utility, Rent Luxury](#). I sold my SF rental house for 30X annual gross rent. I then turned around and invested \$500,000 of the proceeds through 18 different real estate crowdfunding investments trading at only 12X – 15X annual gross rent with 10% – 15% net yields vs. a 2.5% net yield for my SF rental.

If you can follow my BURL rule, I'm confident you will generate more cash flow and have less headaches than those who don't.

A 1031 exchange is great. Just make sure to follow the 1031 exchange rules properly.

Real Estate Recommendations

Shop around for a lower mortgage rate. Check the latest mortgage rates online through [Credible](#). They've got one of the largest networks of lenders that compete for your business.

Your goal should be to get as many written offers as possible and then use the offers as leverage to get the lowest interest rate possible from them or your existing bank. Credible allows you to compare multiple real quotes, all in one place for free. When banks compete, you win. Take advantage of low mortgage rates!

Explore real estate crowdsourcing opportunities. Not interested in following 1031 exchange rules? There is a simpler way to invest in property through real estate crowdfunding. Take a look at [Fundrise](#), one of the largest real estate crowdsourcing companies today.

I personally invested \$810,000 in real estate crowdfunding after selling my rental property. Now I've diversified my real estate exposure and earn income 100% passively.

Real estate is a key component of a diversified portfolio. Real estate crowdsourcing allows you to be more flexible in your real estate investments by investing beyond just where you live for the best returns possible.

For example, cap rates are around 3% in San Francisco and New York City, but over 10% in the Midwest if you're looking for strictly investing income returns.

Sign up and take a look at all the eREITs Fundrise has to offer. **It's free to look.**



Less than 5% of the real estate deals shown gets through the Fundrise funnel

About the Author: Sam began investing his own money ever since he opened an online brokerage account in 1995. Sam loved investing so much that he decided to make a career out of investing by spending the next 13 years after college working at two of the leading financial service firms in the world. During this time, Sam received his MBA from UC Berkeley with a focus on finance and real estate. Sam currently owns four properties in the San Francisco Bay Area and one property in Honolulu. Know your 1031 Exchange rules!

1031 Exchange Rules is a FS original post.