1031 Exchange Help for North Texas Commercial Real Estate Investors

"If we could help you defer a large portion of your capital gains taxes and reinvest all of your equity into a better-performing asset, would you be interested in exploring a 1031 exchange?"

A **1031 Exchange** is a provision in Section 1031 of the Internal Revenue Code that allows an investor to **defer paying capital gains taxes** when they sell investment or business-use real estate and reinvest the proceeds into another qualifying investment property.

Why Investors Use a 1031 Exchange

The primary reason is to **preserve equity and increase purchasing power**.

Without a 1031 exchange:

- Sell property for $1,000,000
- Original adjusted basis = $500,000
- Gain = $500,000
- Federal capital gains tax, depreciation recapture, and potentially state taxes may significantly reduce proceeds available to reinvest

With a 1031 exchange:

- Taxes are deferred
- More equity goes into the replacement property
- Potentially acquire a larger asset that generates more income and appreciation

Common Uses in Commercial Real Estate

1. Trade Up to a Larger Property

Example:

- Sell a $1 million retail strip center
- Exchange into a $2 million office building
- Use deferred taxes as additional equity

2. Increase Cash Flow

Example:

- Sell raw land producing no income
- Exchange into a leased medical office building producing monthly income

3. Reduce Management Responsibilities

Example:

- Sell a small apartment complex requiring active management
- Exchange into a Triple Net (NNN) property leased to Walgreens, CVS, or Dollar General

4. Diversification

Example:

- Sell one industrial property
- Exchange into multiple properties in different Texas markets

5. Consolidation

Example:

- Sell five smaller properties
- Purchase one larger investment asset

6. Estate Planning

Many investors continue exchanging properties throughout their lifetime.

When the owner dies:

- Heirs generally receive a **step-up in basis** to current market value
- Deferred capital gains taxes may effectively disappear

This is one reason many long-term investors call 1031 exchanges "swap until you drop."

Basic Rules

Like-Kind Requirement

For real estate, "like-kind" is broad.

You can exchange:

✅ Land for retail

✅ Retail for multifamily

✅ Office for industrial

✅ Warehouse for self-storage

✅ Farm land for apartments

The properties must be held for:

- Investment purposes
- Business use

Not personal use.

45-Day Identification Period

Within **45 days** of selling the relinquished property, the investor must identify replacement property in writing.

180-Day Closing Deadline

Must complete the acquisition within **180 days** of the sale.

Use a Qualified Intermediary (QI)

You cannot receive the sale proceeds.

The money must go directly to a Qualified Intermediary such as:

- IPX1031
- Exeter 1031 Exchange Services
- First American Exchange Company
- Asset Preservation, Inc. (API)

Typical fee: about **$750-$1,500** for a standard exchange.

Example

Assume your client owns a Dallas retail property:

Item	Amount
Sale Price	$2,000,000
Mortgage Payoff	$500,000
Net Equity	$1,500,000
Potential Taxes	$250,000-$400,000+
Equity Available with 1031	$1,500,000
Equity Available without 1031	Approximately $1.1M-$1.25M

By deferring taxes, the investor may have an additional **$250,000-$400,000** to put toward the next acquisition.

What Doesn't Qualify?

❌ Primary residence

❌ Personal vacation home (unless it meets strict investment-use rules)

❌ House flips held for resale

❌ Stocks, bonds, REIT shares

❌ Partnership interests

Why 1031 Exchanges Matter to You as a CRE Advisor

For your DFW investor clients, a 1031 exchange can help them:

- Move from land into income-producing assets
- Reposition aging properties
- Increase cash flow for retirement
- Consolidate portfolios

- Diversify geographically
- Defer substantial tax liability

A good question to ask every seller is:

1031 Exchange vs. Selling and Paying Taxes

Item	1031 Exchange	Traditional Sale
Capital gains tax	Deferred	Paid at sale
Depreciation recapture tax	Deferred	Paid at sale
Equity available for reinvestment	Higher	Lower
Ability to buy larger property	Greater	Reduced
Complexity	Higher	Simpler
Time deadlines	Strict	None
Qualified Intermediary required	Yes	No
Tax bill today	Typically $0 (deferred)	Due in tax year of sale

Why This Matters

The biggest advantage is that you keep more money working for you instead of sending it to the IRS.

For example, if taxes would have been $150,000, a 1031 exchange allows that $150,000 to remain invested in the next property instead of being lost to taxes today.

Key 1031 Exchange Deadlines

1. Before Closing

Hire a **Qualified Intermediary (QI)** before the sale closes.

Examples:

- IPX1031
- Exeter 1031 Exchange

- Asset Preservation, Inc.
- First American Exchange

Never take possession of the sale proceeds yourself.

If you receive the money directly, the exchange generally fails.

---

2. Day 0 - Close on the Sale

The relinquished property closes.

The QI receives the funds.

The clock starts.

---

3. Day 45 - Identification Deadline

Within **45 calendar days**, you must identify replacement property in writing.

Most investors use the "3 Property Rule."

Example:

1. 100 Main Street Retail Center
2. Oak Ridge Apartments
3. West Loop Industrial Warehouse

At least one of these identified properties must ultimately be purchased.

---

4. Day 180 - Purchase Deadline

Within **180 calendar days** of the original sale:

- Close on one or more identified properties.
- Complete the exchange.

Missing this deadline generally disqualifies the exchange.

Main Requirements

The Property Must Be Investment or Business Property

✅ Apartment complex

✅ Retail center

✅ Office building

✅ Industrial warehouse

✅ Vacant investment land

❌ Primary residence

❌ Flip held as inventory

❌ Personal vacation home

Reinvest Equal or Greater Value

To completely defer taxes:

The replacement property value should generally be:

- Equal to or greater than the property sold.
- All exchange proceeds should be reinvested.
- Debt usually must be replaced as well.

Otherwise, you may create taxable "boot."

Avoid Receiving Cash

Any cash received may become taxable.

Example:

- Sell property.
- Reinvest most of the proceeds.
- Keep $50,000.

That $50,000 will likely be taxable boot.

Simple Example

Scenario A: Regular Sale

Property Sold

- Sale Price: $800,000
- Original Cost Basis: $400,000
- Gain: $400,000

Assume combined federal capital gains and depreciation recapture taxes equal **$100,000**.

Item	Amount
Sale Price	$800,000
Taxes	($100,000)
Remaining Equity	$700,000

Available to buy next property: **$700,000**

Scenario B: 1031 Exchange

Same sale:

- Sale Price: $800,000
- Gain: $400,000

Taxes are deferred.

Item	Amount
Sale Price	$800,000
Taxes Due Today	$0
Reinvested Equity	$800,000

Available to buy next property: **$800,000**

Long-Term Impact

Suppose an investor repeatedly exchanges properties:

Year	Property Value
Start	$800,000
Exchange #1	$1.2M
Exchange #2	$1.8M
Exchange #3	$3.0M
Exchange #4	$5.0M

Because taxes were deferred at each stage, more capital remained invested and compounded over time.

This is why many commercial real estate investors use 1031 exchanges to:

- Build larger portfolios
- Increase cash flow
- Move from active management to passive NNN investments
- Transition from land to income-producing properties
- Diversify or consolidate holdings
- Support estate-planning strategies

A Texas CRE Example

A DFW investor owns 10 acres in Collin County worth **$1.5 million**. Instead of selling, paying taxes, and reinvesting what's left, they exchange into a **$2 million multi-tenant retail center** generating income. The exchange allows more of their equity to remain invested, potentially increasing both cash flow and future appreciation while deferring taxes.

What Is "Boot" in a 1031 Exchange?

Boot is anything of value you receive from the exchange that is not replaced with like-kind real estate.

Common examples:

- Cash you keep from the sale
- Debt that is not replaced
- Non-like-kind property received
- Seller credits or exchange proceeds used for personal expenses

Boot does **not** invalidate the exchange. Instead, it generally becomes **taxable** up to the amount of your realized gain.

Example 1: Cash Boot

Property Sold

Item	Amount
Sale Price	$1,200,000
Adjusted Basis	$700,000
Gain	$500,000

Exchange

Instead of reinvesting all proceeds, the investor keeps $100,000.

Item	Amount
Proceeds Received	$1,200,000
Reinvested	$1,100,000
Cash Kept (Boot)	$100,000

Result:

- Exchange still works.
- $100,000 becomes taxable.
- Remaining gain continues to be deferred.

Think of boot as taking some money off the table while rolling the rest forward.

Example 2: Mortgage Boot

Relinquished Property

Item	Amount
Sale Price	$2,000,000
Mortgage	$800,000

Replacement Property

Item	Amount
Purchase Price	$2,000,000
New Mortgage	$500,000

The investor reduced debt by:

$800,000 - $500,000 = $300,000

Potential result:

- $300,000 may be treated as taxable mortgage boot unless additional cash is contributed to offset the reduction.

Example 3: Full Tax Deferral

Sold Property

Item	Amount
Sale Price	$1,500,000
Mortgage	$500,000

Replacement Property

Item	Amount
Purchase Price	$1,700,000

New Mortgage	$600,000

Result:

✅ Equal or greater value property

✅ All proceeds reinvested

✅ Debt replaced

✅ No cash received

Generally results in complete tax deferral.

Risks of a 1031 Exchange

Many investors focus on the tax benefits but overlook the risks.

1. Missing the 45-Day Deadline

This is probably the biggest risk.

If you cannot identify replacement properties within 45 days:

❌ Exchange fails

❌ Tax becomes due

In a competitive market like DFW, locating suitable assets can be difficult.

---

2. Missing the 180-Day Deadline

Even if you identify a property, financing, inspections, title issues, environmental concerns, or seller delays can prevent closing.

If the transaction does not close within 180 days:

❌ Exchange fails

❌ Taxes become due

---

3. Overpaying for a Property

Some investors become so focused on avoiding taxes that they buy a poor investment.

A bad purchase can cost far more than the taxes avoided.

A common investor saying is:

"Don't let the tax tail wag the investment dog."

The replacement property should still meet investment goals regarding:

- NOI
- cap rate
- tenant quality
- lease terms
- appreciation potential

---

4. Limited Inventory

An investor may be forced to choose among:

- Lower cap rates
- Inferior locations
- Deferred maintenance issues
- Weaker tenants

because the exchange deadlines create urgency.

---

5. Environmental Problems

This is particularly important for commercial properties.

Examples:

- Underground storage tanks
- Dry cleaner contamination
- Gas station contamination
- Asbestos

- Lead
- Mold
- Hazardous waste

An investor may rush due diligence because of exchange deadlines and inherit costly environmental liabilities.

For many commercial acquisitions, a **Phase I Environmental Site Assessment** is standard practice.

---

6. Financing Risk

The replacement property often requires:

- New debt
- Additional equity
- Lender approval

If financing falls apart late in the process, the investor may run out of time and lose exchange benefits.

---

7. Future Tax Is Deferred, Not Eliminated

A 1031 exchange generally postpones taxes.

If the investor later sells without another exchange:

- Capital gains tax becomes due.
- Depreciation recapture becomes due.

The tax bill can grow significantly after several successful exchanges.

Limitations of a 1031 Exchange

Cannot Exchange Into a Personal Residence

❌ Sell an apartment building

❌ Buy a personal home

Not eligible.

Cannot Exchange Stocks or REITs

Not eligible:

- Stocks
- Bonds
- Mutual funds
- REIT shares
- Cryptocurrency

Only qualifying real property held for investment or business use.

Requires a Qualified Intermediary

The investor cannot touch the money.

If sale proceeds are deposited into the investor's account, the exchange can fail.

Additional Costs

Typical costs include:

Item	Typical Cost
Qualified Intermediary	$750-$2,000+
Attorney	Varies
CPA Consultation	$500-$5,000+
Environmental Reports	$2,500-$7,500+
Appraisals	$3,000-$10,000+

Practical Example for a Texas Investor

Suppose a Collin County landowner sells 20 acres for **$3 million**.

Option 1: Pay Taxes

- Gain = $1.5 million
- Combined federal capital gain and depreciation recapture taxes could significantly reduce available proceeds
- Remaining equity might be approximately $2.5 million to reinvest (actual tax depends on basis, depreciation, state and federal circumstances)

Option 2: 1031 Exchange

- Entire $3 million equity rolls into a replacement property
- Investor acquires a $4.5 million retail center with financing
- More cash remains invested and potentially income-producing

The tradeoff is that the investor must:

- Meet strict deadlines
- Find a suitable replacement asset
- Complete due diligence
- Continue holding investment property rather than cashing out

For many commercial real estate investors, the 1031 exchange is one of the most powerful wealth-building tools available because it allows capital that would have gone to taxes to continue compounding in larger real estate investments.

How to Avoid Boot in a Future 1031 Exchange

When advising an investor, the goal is usually **100% tax deferral**, which means avoiding both **cash boot** and **mortgage boot**.

Rule #1: Buy Equal or Greater Value

If the relinquished property sells for **$2,000,000**, purchase replacement property worth at least **$2,000,000**.

Good Example

Item	Amount
Sale Price	$2,000,000
Replacement Purchase	$2,250,000

✅ No value-related boot

Potential Problem

Item	Amount
Sale Price	$2,000,000
Replacement Purchase	$1,800,000

⚠ Potential taxable boot of approximately $200,000

Rule #2: Reinvest All Net Equity

Suppose:

Item	Amount
Sale Price	$2,000,000
Loan Payoff	$500,000
Net Equity	$1,500,000

To maximize tax deferral:

- Reinvest all $1,500,000
- Do not take cash from closing

Bad Example

Investor takes $100,000 cash.

Result:

- $100,000 cash boot
- Potentially taxable

Rule #3: Replace the Debt

If the relinquished property had:

- $800,000 mortgage

Then the replacement transaction generally needs:

- $800,000+ new financing

OR

- Additional cash contribution

Example

Old debt = $800,000

New debt = $500,000

Shortfall = $300,000

Investor can contribute $300,000 cash to offset the debt reduction.

Result:

✅ Avoid mortgage boot

Rule #4: Watch Closing Statements Carefully

Potential hidden boot items include:

- Security deposits

- Tenant prorations
- Repair credits
- Escrow refunds
- Exchange proceeds used for non-exchange expenses

Have:

- Qualified Intermediary review settlement statements
- CPA review transaction structure
- Closing attorney review allocation of funds

Rule #5: Leave a Margin of Safety

Instead of exchanging into a property worth exactly the sale price, many investors target:

105%-120% of relinquished value

Example:

Relinquished Sale	Target Acquisition
$1,500,000	$1,700,000-$1,800,000

This helps avoid accidental boot from adjustments and closing costs.

For more information contact:

Barb.Cole@CBRealty.com

Coldwell Banker Commercial Worldwide-TX.

“Serving CRE Property Owners Around Texas & Around The Globe”

“Collaboration With Coldwell Banker Brokers & Other CRE Brokers Around The Globe”