Will a 1031 Exchange Help Grow Your Portfolio?

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Chris Clothier began building his rental portfolio in 2003 as a successful entrepreneur looking to diversify his investments. He quickly gravitated toward passive investing, establishing a portfolio of over 50 single family homes in Memphis, Tenn. As an original client of his family’s firm Memphis Invest (now [REI Nation](https://www.reination.com/)), Chris experienced firsthand what a passive investor endures when purchasing out of state. In 2007, Chris moved his company and family back to Tennessee, wound down his brokering company, and joined REI Nation as a partner and director of sales and marketing.

Experience
Since joining REI Nation, the business has grown into the premier turnkey investment company in the country and a standard bearer for best practices in the industry, managing over 6,000 investment properties for 2,000 passive clients. In addition to managing the development and implementation of sales and marketing processes, Chris serves as an ambassador for the company, working with the team to help potential investors define their purpose for investing in real estate and educating peer companies on best practices.

REI Nation clients’ portfolios hold a value of close to $800 million in single family assets in seven cities. The company has been featured as a six-straight year honoree in Inc. magazine’s list of the 500/5,000 “Fastest Growing Companies in America.”

In 2019, Chris’ team assisted 600 investors with purchasing just under 1,000 fully-renovated and occupied turnkey homes. Chris led the re-brand of his family’s company on January 1, 2020, from Memphis Invest to REI Nation.

Chris is also an experienced real estate speaker and addresses small and large audiences of real estate investors and business professionals nationwide several times each year, including IMN single family conferences, the PM Grow property management conference, and the Ignite conference in Las Vegas each December.

Chris continues to hold a sizable single-family rental portfolio in both Tennessee and Texas. Along with his family, he owns several commercial buildings in the greater Memphis area.

When not working with the team at REI Nation, Chris is busy raising five kids, operating a racing company in Memphis, and serving as CEO for The Cancer Kickers Soccer Club, a Memphis-based 501c3 providing comfort and care for kids battling childhood cancers.

Founded in 2017 by Chris and Michelle Clothier, the non-profit organization focuses on providing a team environment for kids to find encouragement and strength in their battle. The company worked with over 500 children from six countries in 2019.

Press
Chris has been featured in stories published in Money Magazine, The New York Times, The Wall Street Journal, and DN News, as well as the Memphis Business Journal. In 2018, McGraw-Hill Publishing purchased Chris’ manuscript, [The Turnkey Revolution](https://amzn.to/2QtHC3V), and worked with Chris to publish his first book in May 2018.

Chris also publishes two weekly blogs at [ChrisClothier.com](http://www.christopherclothier.com/blog) and [REINation.com](https://blog.reination.com/). Chris has also published articles on the BiggerPockets Blog since 2009.

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We all know the basic benefits of real estate investment: cash flow, growing equity, tax advantages, and much more. However, there are many strategies and tools available to make your portfolios and investments even more valuable.

My family’s business has been out in front of the turnkey real estate investment niche for almost 20 years. We’ve seen it all. The biggest mistake we’ve seen is not understanding how to reposition your portfolio for an exit strategy. Having an understanding of exit strategies is massively important no matter whether you intend to hold a property for five years or decades

Too often investors think of exit strategies in a negative way. Sometimes exit strategies are part of the plan to grow and diversify, and 1031 exchanges as an exit strategy are definitely not a negative thing.

A 1031 exchange is one of the best strategies to have in mind as a real estate investor. But what is it and when should you make an exchange?

The 1031 exchange rundown

Before I dive into the 1031 exchange details, let’s talk in terms of basics. A 1031 exchange is when an investor swaps one property for another property (or properties) while deferring capital gains taxes.

The name of the exchange comes from the IRS code Section 1031. Because we’re dealing with the IRS and taxes, it’s extremely important to get this done right. Real estate investors have the distinct advantage of tax deferrals, exemptions, and incentives. A mistake in this area can have significant ramifications on the bottom line.

Quick things to note

* There is no limit to how many times a 1031 exchange can be performed.
* Properties exchanged must be like-kind in the eyes of the IRS and be used for either investment or business purposes. Vacation and secondary homes are subject to specific limitations.
* The 1031 exchange does not necessarily have to be a trade of one property for one property.
* An exchange cannot be made if either property is “stock in trade.” Homes built and sold by developers are “stock in trade.” Flipped properties immediately put on the market after improvements are “stock in trade.” If an investor does not hold a property for investment and immediately tries to use the property for another exchange, the property may not qualify.
* Personal or intangible property cannot be exchanged.
* If there is a price disparity between exchanged properties (if you buy something cheaper), there are tax considerations in the difference.
* If you exchange mortgage liabilities, the difference in the outstanding debt, if lower than your previous liability, is considered “boot” and is taxable as capital gains.

Real estate investors who want to use this strategy must consult a professional intermediary. Your tax advisor, financial planner, or CPA should be made aware of your intent to perform an exchange well before it happens. This is to ensure that you do not miss any steps, deadlines, or qualifiers. The [IRS has special rules for 1031 exchange](https://www.irs.gov/pub/irs-news/fs-08-18.pdf) programs and it is important that you hit those rules perfectly.

How a 1031 exchange happens

This is, in basic terms, the process of completing a 1031 exchange:

1. A property is put on the market for sale. This is your “relinquished property.” Once it is under contract, the process really begins.
2. Identify a qualified intermediary (QI), also known as an accommodator or facilitator. They can be independent or institutional. Because you cannot hold any of the money made from the sale of your relinquished property, your QI will hold the funds until you identify a replacement property. Once the property is identified, the funds are released to acquire it. Before you close on the sale of your relinquished property, you must have a qualified intermediary. If you do not, you will be disqualified from this particular exchange.
3. Identify your replacement property within 45 days of the close of sale on your relinquished property. Within 45 calendar days, your qualified intermediary must be notified of your replacement property.
4. Close the deal within 180 days of the closing on your relinquished property—not from the identification of the replacement. You cannot amend a tax return to include an exchange, so you should wait to file annual taxes for the calendar year in which the exchange occurred until the exchange is complete.
5. Talk to your tax advisor or CPA once the exchange is complete so that the proper forms can be prepared for filing.

How a 1031 exchange benefits investors

Now that we have a basic idea of what a 1031 exchange entails, why should an investor pursue this option? Believe it or not, the benefits of a like-kind exchange go far beyond just tax deferral.

Tax benefits

Of course, tax benefits are one of the biggest advantages to a 1031 exchange. Because your exchange is tax-deferred, you do not have to pay capital gains taxes for the sale of your sold property. You only have to pay these down the line should you choose to sell other existing investment properties (provided you are not performing another exchange). Depreciation recapture taxes are also deferred.

This essentially makes it so an investor only has to pay capital gains taxes once*.*This is enormously beneficial in a scenario where there is no outstanding debt on the property and it has appreciated seemingly to its limit. An investor can “trade up” to a more suitable investment while avoiding these costly taxes.

Market access & diversification

[Portfolio diversification is key to success in real estate investment](https://www.kiplinger.com/real-estate/real-estate-investing/601684/how-to-build-a-diversified-real-estate-investment). That much we know. That doesn’t mean, however, that we’re always in the right markets.

Part of what 2020 showed the real estate world was that the expensive coastal cities aren’t all they’re cracked up to be. They may have a long-lauded reputation with some investors, but volatility in the markets tends to shake these markets first and most. As market desirability shifts, we find ourselves looking inland to smaller but growing investment markets.

A 1031 exchange allows an investor to capitalize on a new market while also removing themselves from a market that has experienced a downturn. No matter the reason, a 1031 is a great way to rest.

Because an exchange does not have to be one-for-one, an investor could theoretically exchange one high-value investment property, such as a multifamily unit or commercial building, for a whole portfolio of smaller, more stable, and more consistent real estate investments.

Access to new markets and varied asset classes is a great benefit.

Pivoting your strategy

Are you unhappy with your real estate investments? A 1031 exchange can be a way to “unload” an under-performing property in exchange for something more valuable. If you want to invest in a new type of property, a 1031 exchange accomplishes this with lower personal cost to you.

If you own an investment or business property that appreciated but has other consistent issues or poor performance, you can use the exchange as an opportunity to gain a higher-value property. A higher-value property can then help generate more cash flow and increase your overall equity.

Resetting depreciation

In real estate, depreciation is used to deduct the costs of renovating or maintaining a property over its “useful life.” The IRS says this is 27.5 years, and depreciation benefits are spread across that timeframe. Unfortunately, assessors aren’t usually up-to-date on your property’s improvements and its value unless there has been a sale. Your depreciation value, then, usually has to do more with its value at purchase and the appreciation you may have gained since.

In a way, a 1031 exchange allows you to “reset” depreciation. You can utilize the appreciated value of your sold property to acquire an investment where depreciation will be more on-par with the property’s actual value.

1031 exchange pitfalls

As with anything in investing, there are risks involved. A like-kind exchange is no different. There are some major considerations to be had before you engage in an exchange. After all, no strategy is one-size-fits-all and the challenges posed by a 1031 exchange may be enough to deter you from trying it yourself. Remember, consult a [qualified intermediary](https://www.cpajournal.com/2016/10/01/selecting-a-qualified-intermediary-for-a-like-kind-exchange/) early.

Tight timeline

Perhaps one of the biggest challenges in performing a successful 1031 exchange is the timeline. You have a total of 180 days to complete the process, plus a 45-day deadline in the middle. While 180 days seems like quite some time, that six months or so will go by in a flash.

Because buy-and-hold real estate investors are often used to a more relaxed, passive approach to real estate, handling the deadlines and time-intensive decision-making may prove more challenging than expected.

Investors should prepare for a 1031 exchange far in advance. It is not a venture to take on spur of the moment. Finding a like-kind property can be difficult and overwhelming. Investors will want resources and contacts in place for finding and facilitating an exchange ahead of time. This way, there will be less pressure on you to meet the deadlines because finding and closing on a suitable property becomes that much easier.

The boot

I mentioned “boot” earlier. This refers to any residual earnings from your sold property. Residual earnings would be where your new property was bought at a price lower than the cash you received from the sale. This extra leftover cash is called “boot.” The qualified intermediary will return these funds to you once the exchange is complete, but at a cost.

Capital gains taxes are due on any amount leftover in an exchange. This is also true of liability, as I mentioned earlier. If you had $200,000 worth of liability on a single property and exchanged it for a property with only $150,000 outstanding in liability, the difference is also treated as boot and is thus taxable.

Starting too late

Perhaps the biggest thing I see is investors who decide they want to do a 1031 exchange at the last minute. At that point, it’s usually too late to qualify. Again, you want to establish your intent to exchange with your team and advisors and have a qualified intermediary lined up. While the process doesn’t start until you have closed on the property you are selling, you must be prepared long before that point.

Inform the relevant parties and get your QI established. This will allow the process to move smoothly and successfully.

A parting word

My real piece of advice to you as a real estate investor is to consult with professionals that you trust. Then be patient. Don’t rush into any decisions and certainly don’t just use a 1031 exchange because it sounds like a good idea. Understand what you are trying to accomplish and why.

Where taxes are concerned, you can rest assured that there will be a lot of information to wrap your mind around. This is only a basic overview of how a 1031 exchange is done and why.

If you’re interested in an exchange, talk to your CPA, tax or wealth advisor, or a trusted investment company that can help you through the process. The sooner you do this, the more clear and intentional your next steps will be.

The main reason for a 1031 exchange is growth and efficiency. This means that before you start, make sure you know what you want to accomplish as an investor. Know what kind of properties you want and where, and what kind of owner you want to be. This is a great tool to use, but only if it is moving you toward your goals.

Ultimately, when you know yourself as an investor and have your sights set on long-term goals, you will best be able to determine whether or not a 1031 exchange is right for you.