1031 Exchange Coming Up? Know the Options Before You Reinvest

Here’s a look at 4 replacement options for 1031 exchange investment.

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If you have a [1031 exchange coming up](https://www.nreionline.com/net-lease/so-your-1031-exchange-deadline-has-been-extended-why-waiting-until-july-deadline-could-be), you have multiple choices to reinvest the proceeds from your sale. That’s a good thing, because coming out of your prior investment, maybe you’re tired of the three Ts—tenants, toilets and trash—and you’d rather leave the day-to-day property management to others.

A 1031 exchange (also known as a like-kind exchange) allows an investor to [defer capital gains, depreciation recapture and other taxes](https://www.nreionline.com/investment/trump-tax-saga-shines-spotlight-benefits-cre-ownership) at the time an investment or business property is sold if the net equity from the sale is reinvested in a property of the same or greater value. Fortunately, “property” does not mean the proceeds have to be reinvested directly into another property that you purchase outright and manage on your own. There are multiple ways the gain can be reinvested to qualify for preferential tax treatment.

#1: Qualified Opportunity Zone funds

[Qualified Opportunity Zone funds](https://www.nreionline.com/investment/opportunity-zone-funds-work-regain-momentum), which were enabled by the Tax Cuts and Jobs Act of 2017, offer benefits including tax deferral and elimination that many investors nationwide have utilized. A fund of this type can invest in real property or operating businesses within an Opportunity Zone, typically a geographic area in the U.S. that has been so designated because it may be underserved or neglected. As such, there may be a higher level of investment risk. Also, the time horizon of the fund may be as long as 10 years, which means tying up your capital for that length of time in an illiquid fund.

If you seriously consider this investment option, be aware that these funds may have been set up to invest in only one property or business, in which case there is no diversification. But the opposite may also be true. With a fund of this type, there can be potential cash flow and appreciation, as well as positive economic and social impacts on a community. This fund option also works if you are selling other appreciated assets like stocks or businesses.

#2: Tenants-in-Common cash-out

In addition to using a 1031 exchange to defer taxes, some investors also want to improve liquidity so they can potentially take advantage of other buying opportunities in the future. With a Tenants-in-Common (TIC) investment, you own a fractional interest in a commercial, multifamily, self-storage or other type of investment property. The TIC cash-out is a specific strategy where the investment property is purchased using zero leverage, so it is debt-free, with no mortgage going in. Then, after a year or two, the property can be refinanced at 40 percent to 60 percent loan to value, effectively providing investors with a large portion of their initial invested principal tax-free in the form of a cash-out refinance. Under this scenario, the remaining equity in the investment stays in the TIC property, providing potential distributions to investors while they get to enjoy liquidity with a large portion of their funds.

#3: Direct purchase of triple-net (NNN) properties

With a triple-net leased property, the tenant is responsible for the majority, if not all, of the maintenance, taxes and insurance expenses related to the real estate. Investors utilizing a 1031 exchange are often interested in purchasing NNN properties, which typically are retail, medical or industrial facilities occupied by a single tenant. On the surface, these investments may seem passive, but there are three distinct downsides, namely concentration risk if an investor places a large portion of their net worth into a single property with one tenant; potential exposure to a black swan event like COVID-19 if the tenant turns out to be hard hit; and management risk.

Remember the three Ts I alluded to above. If you’d prefer a passive investment, the direct purchase of a triple-net property is likely not for you. Others may allude to triple-nets being management-free. However, having owned dozens of net-lease properties throughout my career, I can tell you that they are anything but management-free. (Just ask my in-house legal counsel, and asset management and accounting teams.)

#4: Delaware Statutory Trusts

In contrast to the example above where you buy the whole property yourself, Delaware Statutory Trusts (DSTs) are a form of co-ownership that allows diversification and true passive investing. Most types of real estate can be owned in a DST, including retail, self-storage, industrial and multifamily properties. A DST can own a single property or multiple properties. In a 1031 exchange scenario, you can invest proceeds from the prior property sale into one or more DSTs (holding one or more properties) to achieve diversification.

DSTs often hold institutional-quality properties. The properties could be occupied by single tenants operating under long-term net leases, such as a FedEx distribution center, an Amazon distribution center, a Walgreens pharmacy or a Fresenius dialysis center. DSTs can be one of the easiest 1031 replacement property options to access because the real estate already has been acquired by the DST sponsor company that offers the DST to investors.

Regardless of the approach you choose to reinvest the proceeds from your prior sale, the net effect of 1031 exchange investing is generally the same. The initial invested capital and the gain can continue to grow, potentially, without immediate tax consequences. Then, if and when the new investment is sold down the road without the equity reinvested in another exchange property, the prior gain would be recognized.