How Does a 1031 Exchange Work for North Bay Apartment Owners?

A 1031 exchange allows an apartment owner to defer taxes on a sale by buying another qualifying investment property. It does not erase the tax, and the exchange must be set up before the apartment property closes.

A successful exchange can preserve more of your equity for the next investment. However, you must follow strict deadlines and cannot take control of the sale proceeds.

Here is how the process works.

What Is a 1031 Exchange?

Section 1031 of the Internal Revenue Code allows an owner to exchange investment or business real estate for other qualifying real estate without paying all the tax at the time of the sale.

The key word is **defer**. The tax may become due when you sell the replacement property unless you complete another qualifying exchange.

Both properties must generally be held for investment or business use. A personal residence and property held mainly for resale usually do not qualify. IRS Publication 544 explains the basic requirements.

Because every owner's tax situation is different, you should review the exchange with a CPA or tax attorney.

Do You Have to Buy Another Apartment Building?

No. "Like-kind" does not mean the properties must be identical.

An apartment building may potentially be exchanged for:

- Another multifamily property
- An industrial building
- A retail or office property
- A mixed-use investment
- Land held for investment
- More than one replacement property

Both the property you sell and the property you buy must qualify as investment or business real estate. U.S. property cannot be exchanged for property outside the United States.

This flexibility may allow you to increase income, enter a new market, reduce management demands, or diversify your investments.

What Should You Do Before Selling?

Begin planning before the apartment property goes on the market.

Your team may include:

- A CPA or tax attorney
- A qualified intermediary
- A commercial real estate advisor
- An escrow or title professional

Your real estate advisor can help determine the property's value, prepare it for sale, and begin searching for replacement options. Your tax and legal advisors should confirm that the exchange and ownership structure qualify.

Most delayed exchanges use a qualified intermediary to hold the sale proceeds and manage the exchange documents. This arrangement should be established before the property closes.

You cannot receive or control the sale proceeds. If you do, the transaction may be treated as a taxable sale.

What Happens After the Property Sells?

At closing, the proceeds are transferred to the qualified intermediary under the exchange agreement.

The closing also starts two important deadlines:

- **45 days to identify possible replacement properties**
- **180 days to acquire the replacement property, or until your tax return is due, including extensions, if that date comes first**

These deadlines run at the same time. You do not receive another 180 days after the 45-day identification period ends.

Because the schedule is tight, you should begin looking at replacement properties before your apartment sale closes.

How Do You Identify Replacement Properties?

The replacement property must be identified in writing within 45 days. The document must clearly describe the property, usually with an address or legal description.

The most common identification choices are:

- **Three-property rule:** Identify up to three properties, regardless of value.
- **200% rule:** Identify more than three properties if their combined value does not exceed twice the value of the property you sold.
- **95% rule:** If you exceed those limits, you may need to acquire at least 95% of the total value you identified.

These rules can become complicated. Have your qualified intermediary and tax advisor review the identification before the deadline. [IRS Publication 544] provides more detail.

How Long Do You Have to Complete the Purchase?

You generally must receive the replacement property by the earlier of:

- The 180th day after transferring the property you sold, or
- The due date of your tax return for that year, including extensions

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You must acquire the same property that was properly identified.

Financing, inspections, appraisal, title work, and other due diligence must all be completed within this period. Choose replacement properties that fit your goals and have a realistic chance of closing on time.

The [IRS Form 8824 instructions] explain the current timing rules.

Could Part of the Exchange Still Be Taxable?

Yes. Part of the gain may be taxable if you receive cash, buy nonqualifying property, or have debt relief that is not offset in the replacement transaction.

Buying a less expensive property or failing to reinvest all the available proceeds may also affect how much tax is deferred.

Your CPA or tax attorney should calculate the possible tax based on your sale price, adjusted basis, debt, closing costs, and replacement property.

Do not judge the exchange only by comparing the sale and purchase prices.

What Mistakes Should You Avoid?

Common mistakes include:

- Waiting until closing to contact a qualified intermediary
- Taking control of the sale proceeds
- Missing the 45-day or 180-day deadline
- Identifying property incorrectly
- Buying a weak investment just to meet the deadline
- Failing to coordinate with tax and legal advisors
- Forgetting to report the exchange on IRS Form 8824

A 1031 exchange can follow every tax rule and still be a poor decision if the replacement property does not fit your investment goals.

What Is the Main Takeaway?

A 1031 exchange works best when the tax plan and property strategy are in place before your apartment sale closes.

Tax deferral is valuable, but it should not be the only goal. The replacement property still needs the right income, location, condition, financing, and long-term potential.

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Are You Considering Selling a North Bay Apartment Property?

If you own an apartment property in Marin, Sonoma, or Napa County and are considering a sale or 1031 exchange, I can help you evaluate the property, prepare it for market, and explore replacement options.

I coordinate the real estate process with your qualified intermediary, CPA, attorney, and other advisors. I do not provide tax or legal advice.

The best time to begin is before the property goes under contract.

[Schedule a 15-minute conversation about your apartment property and investment goals.]

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