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Is the 1031 exchange always the right answer?

Most real estate investors are familiar with the 1031 exchange. For decades, it has served as one of the most effective tools for deferring capital gains taxes and preserving investment capital following the sale of appreciated real estate. Countless investors have used successive exchanges to grow portfolios, defer tax liabilities and build long-term wealth.

But as investors accumulate assets and their objectives evolve, a fundamental question often receives less attention than it deserves: Is continued tax deferral always the best outcome?

The answer, in many cases, is more nuanced than investors and advisers may initially assume.

The 1031 exchange remains a valuable planning tool, but it is not the only consideration when evaluating a property sale. Portfolio diversification, liquidity, management responsibilities, estate planning and overall investment flexibility can become equally important factors. In certain situations, an investor's long-term objectives may be better served by evaluating alternatives rather than automatically pursuing another exchange.

The challenge is determining when tax deferral remains the primary objective and when broader portfolio considerations deserve greater attention.

The appeal of the 1031 exchange

The popularity of the 1031 exchange is easy to understand. Under Section 1031 of the Internal Revenue Code, investors may defer recognition of capital gains when selling an investment property and acquiring a qualifying replacement property. By postponing taxes, investors preserve more capital for reinvestment and potentially increase their ability to compound wealth over time.

For investors focused on long-term accumulation, the benefits can be significant. Many property owners have successfully completed multiple exchanges over decades, continuously rolling equity into larger or more valuable assets. In some cases, investors hope to continue exchanging throughout their lifetime, potentially allowing heirs to inherit assets at a stepped-up basis.

There is a reason the strategy has remained a fixture in real estate investing for generations. Yet the success of the 1031 exchange can create unintended consequences.

Evaluating more than the tax outcome

Over time, repeated exchanges can result in significant deferred gains. As potential tax liabilities grow, investors may become increasingly focused on preserving deferral when evaluating future opportunities.

Rather than asking whether a prospective investment is attractive on its own merits, investors sometimes find themselves focused primarily on avoiding gain recognition.

This dynamic can become particularly apparent when investors face strict exchange deadlines. Replacement properties generally must be identified within 45 days of a sale and acquired within the prescribed exchange period. Those timelines are manageable when suitable opportunities are readily available. They can become considerably more challenging when market conditions are uncertain or when investors are seeking greater flexibility.

In some situations, investors may feel pressure to acquire a property that falls short of their ideal investment criteria simply to preserve tax deferral.

The exchange achieves its tax objective but may not achieve the investor's broader portfolio objective.

Looking beyond traditional exchanges

None of this suggests that investors should abandon 1031 exchanges.

Rather, it suggests that investors should evaluate all available options before assuming another exchange is the only logical path forward.

One lesser-known approach that occasionally enters these discussions is the Passive Loss Release Strategy. At a high level, the concept involves recognizing gain from the sale of an investment property while simultaneously investing in opportunities that may generate passive losses. In certain situations, passive losses can be used to offset passive income, subject to applicable tax rules and investor-specific circumstances.

Importantly, this is not a universal solution. Tax outcomes depend heavily on individual circumstances, and investors should always evaluate these considerations alongside qualified tax and legal advisers.

Advisers and investors may benefit from beginning with desired outcomes and then evaluating the most appropriate structure to support those objectives.

A hypothetical example*

Consider a simple scenario involving the following assumptions:

- Investor is not a “real estate professional” as defined in the tax code
- Gain on sale is considered passive income
- $1 million in sale proceeds
- Taxable gain from sale of $500,000 at an assumed marginal tax rate of 30 percent (combined federal, state, depreciation recapture, net investment income tax)
- Investor has greater than $500,000 of ordinary income at an assumed marginal tax rate of 47 percent (combined federal/state)

The traditional response would be to complete a 1031 exchange and defer recognition of the gain.

However, the investor could also evaluate an alternative approach. Suppose the investor contributes the $1 million of sale proceeds into MLG Fund VII, MLG Capital's diversified private real estate fund focused on acquiring commercial real estate investments across multiple markets and property sectors, during the same tax year. Based on MLG's historical operating experience, Fund VII may generate first-year passive loss allocations of approximately 50 percent of invested capital. Under this assumption, a $1 million investment could produce approximately $500,000 of passive loss allocations.[1]

Because the investor's gain from the property sale is treated as passive income, those passive losses may become available for use under the passive activity loss rules, subject to the investor's individual tax circumstances and applicable IRS regulations.

Importantly, once released, the losses are generally ordinary losses. Depending on the investor's tax profile, those losses may potentially be used to offset ordinary income that could otherwise be taxed at significantly higher rates than long-term capital gains.

Under the assumptions above, the analysis could look like this:

- Recognized passive capital gain: $500,000
- Estimated tax liability on gain (30 percent): $150,000
- Investment into MLG Fund VII: $1 million
- Estimated first-year passive loss allocation (50 percent of commitment): $500,000
- Ordinary income offset by released passive losses: $500,000
- Estimated tax reduction on ordinary income (47 percent): $235,000

In this hypothetical scenario, the estimated tax reduction of $235,000 exceeds the estimated $150,000 capital gains tax liability, potentially resulting in a net tax benefit of approximately $85,000.

The investor also receives the potential benefits of a diversified private real estate portfolio, professional management and exposure across multiple properties, markets and operators, rather than exchanging into a single replacement asset.

Changing objectives require different conversations

One reality of wealth management is that investor priorities evolve. An investor in the early stages of portfolio growth may be focused primarily on asset accumulation and appreciation. Twenty years later, those priorities may look very different.

Many experienced real estate owners eventually begin asking questions that have less to do with taxes and more to do with lifestyle, risk and portfolio construction:

- How concentrated is my wealth in a particular property or market?
- Do I still want active ownership responsibilities?
- How should I think about succession planning?
- Would broader diversification improve my portfolio?
- Is flexibility becoming more valuable than maximum tax deferral?

The challenge is that tax considerations can sometimes overshadow these broader planning discussions.

Recognizing gain can feel uncomfortable, especially after decades of successful exchanges. Yet avoiding taxes should not become the sole objective if doing so prevents investors from adapting their portfolios to changing circumstances.

A better framework for advisers

For advisers, the most valuable role may be helping clients evaluate property sale decisions within the context of broader financial objectives. Rather than focusing solely on tax consequences, conversations should also consider portfolio concentration, liquidity needs, investment preferences, estate planning objectives and the desired role of real estate within the overall wealth picture.

The 1031 exchange remains a powerful planning tool and, for many investors, will continue to be an appropriate solution. However, as portfolios mature and objectives evolve, alternative approaches may warrant consideration.

Ultimately, the goal is not simply to defer taxes. It is to select a strategy that aligns with an investor's long-term goals, lifestyle objectives and overall portfolio needs.

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CORPORATE OVERVIEW

MLG Capital is a private real estate investment firm founded in 1987 and headquartered in Brookfield, Wis. The firm invests in multifamily, industrial and other commercial real estate nationwide and manages approximately $6.6 billion in real estate market value. Through its investment platforms, MLG Capital provides accredited investors and other qualified investors access to diversified private real estate investments.

For more information, visit www.mlgcapital.com/RAA

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1) Assumption is made based on data from actual year 1 passive loss allocations from MLG's series of private real estate funds. Actual historical results varied within the stated range based on an investor's investment timing and the funds acquisition of properties in such year. Passive taxable losses and carryovers (if they are released by passive income) will be reduced after year 1 of an investment into a fund.

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