§1031 TAX-DEFERRED EXCHANGES



JUST THE BASICS:
TAX-DEFERRED EXCHANGES UNDER I.R.C. § 1031

Knowing some basic rules behind Internal Revenue Code §1031 can help investors defer paying capital gain tax on property dispositions, resulting in more money to invest in a property acquisition. Generally, any real or personal property can be exchanged, provided it is held "for productive use in a trade or business" or for "investment" and is exchanged for property of "like-kind" that will also be held for one of these same purposes.

Exchange of Property

The first requirement of a 1031 exchange is that the transaction must be structured as an exchange, rather than as a sale and purchase. In order to accomplish this, a qualified intermediary must be involved with the sale of the relinquished property (property sold) and acquisition of the replacement property (property acquired). To ensure that the transaction is considered an exchange, rather than a sale followed by a purchase, the investor must sign an exchange agreement, assignment of the purchase contract, as well as other documentation before the relinquished property sells, and the intermediary must hold the proceeds until they are used to buy the replacement property. As long as the appropriate documentation is signed, the intermediary does not need to take title to the property.

Like-Kind Requirement

The replacement property must be considered "like-kind" to the relinquished property. The like-kind requirement is fairly broad for real property exchanges. For example, an office building can be exchanged for vacant land, an apartment building can be exchanged for a single family rental home, or a duplex can be exchanged for a retail strip center; basically any real property held for investment qualifies as "like-kind."

Same Taxpayer Rule

In order to qualify for tax deferral treatment, the same taxpayer selling the relinquished property must purchase the replacement property. For example, if Company B sells the relinquished property, Company B must also acquire the replacement property. An exception to this requirement is entities that are considered disregarded for tax purposes, such as single member limited liability companies and revocable trusts. For example, Sue Smith may own a commercial building in her own name. She can sell that property and acquire replacement property in her own name, or she may take title in the name of a limited liability company in which she is the sole member, or she may create a revocable trust and take title in the name of the trust. In each case, Sue Smith is still considered the same taxpayer thus allowing her to complete an exchange.

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Holding for Investment Purposes

Both the relinquished and replacement properties must be held for investment purposes or for use in the investor's business. Property that is held for the purpose of appreciation or for rental income should satisfy the investment requirement. Typical exchange transactions involve an office or commercial building, a rental home or an apartment building. Personal residences, vacation homes frequently used by the owner, and property held for sale (i.e., new homes constructed by a homebuilder) would not qualify. Mixed use properties such as home offices or duplexes in which the investor lives in one unit and rents the other unit can qualify for a tax-deferred exchange for the portion of the property used for business or investment purposes.

The tax code does not clearly specify a minimum time frame that an investor must continue to hold the investment property to qualify for tax deferral treatment. However, when the IRS examines exchange transactions, the investor must be able to show that the investor intended to hold the property for investment purposes at the time it was acquired. If an investor only holds his replacement property for a few months prior to selling it, the IRS may question whether the investor actually intended to hold the property for investment purposes.

Deferring All Tax

In order to defer all tax completely, the property that the investor is purchasing must be equal or greater in value, equity, and debt (but the debt can be replaced with cash) than the relinquished property. If any of these criteria are not met, the exchange may still be valid; however the transaction will likely be at least partially taxable.

Timing and Identification

The investor has 45 days from the closing of the relinquished property to identify replacement property. Proper identification of replacement property is a requirement for a valid exchange, and the investor can only acquire property which has been properly identified during the 45-day identification period. Replacement property that is acquired (i.e., closes) within the 45-day time period is considered properly identified. For property not purchased within the 45-day time frame, the identification must unambiguously describe the property (with an address or legal description), and must be made in writing, signed by the investor and sent before midnight of the 45th day. If multiple relinquished properties are grouped together in one exchange, the 45-day time period starts to run as of the closing of the first property. At First American Exchange, we provide you with forms to help you meet the required guidelines.

If an investor wants to identify more than one replacement property, there are several options. The two most common methods to identify multiple properties are:

***The "Three Property" rule**:* the investor may identify up to three properties without regard to their fair market value; or

The "200%" rule: the investor may identify any number of properties so long as the total fair market value of all of the listed properties does not exceed 200% of the value of the relinquished property.

Once escrow closes on the relinquished property, the investor has the lesser of 180 days from the date of closing, or the date on which the investor's tax return for the year the relinquished property was sold is due, to close the purchase transaction and complete the exchange. For exchanges closing in the final quarter of the year, the taxpayer will need to get an extension to file his tax return to get the full 180 days.

Trust the Experts

Tax-deferred exchanges are an incredible investment tool. When considering a tax-deferred exchange, consult with your tax advisor and contact First American Exchange Company before the sale of the relinquished property. As the national leader in 1031 exchanges, First American Exchange can assist you through every step of the process.

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