What is a 1031 Exchange?

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Section 1.1031 of the Internal Revenue Code of 1986, as amended, offers real estate investors one of the last great investment opportunities to build wealth and save taxes. By completing an exchange, the investor (Exchanger) can dispose of their investment property, use all the equity to acquire replacement investment property. Two requirements must be met to defer the capital gain tax:

(1) the Exchanger must acquire like-kind replacement property and (2) the Exchanger cannot receive cash or other benefits (unless the Exchanger pays capital gain taxes on this money). The tax code states: "No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment purposes of such property is exchanged solely for property or a like-kind which is to be held for either productive use in trade or business or for investment purposes." Investors can accomplish virtually any investment objective with exchanges including greater leverage, diversification, freedom from joint ownership, improved cash flow, geographic relocation and/or property consolidation.

Relinquished Property
The "first leg" of the exchange begins when the Exchanger enters into a sale transaction for the transfer of Exchanger relinquished property to a purchaser. The Exchanger then assigns his/her rights under the sale agreement to the Exchanger as the qualified intermediary. The proceeds from the sale are given to the Exchanger in the form of cash and/or notes, depending upon the structure of the transaction.

The Exchanger can accept a promissory not as part of the sale transaction. The Exchanger can then use the note as part of the replacement property consideration OR during the course of the exchange sell the not for cash to complete the exchange.

Replacement Property
The "Second leg" of the exchange begins when the Exchanger has found and identified suitable "like-kind" replacement property.

Congress has set time deadlines as to when the identification of the replacement property has to occur and when the replacement property must be transferred.

The identification of the "like-kind" replacement property must occur within 45 days of the transfer of the relinquished property.

The replacement property must be acquired on or before the earlier of the following dates: (a) 180 days from the date of the transfer of the relinquished property, OR (b) the date the tax return is due for the tax year in which the transfer of the relinquished property occurred. However, the taxpayer does have the right to extend the due date for the tax return under the applicable rules for extension.

The following examples can be considered "Like-Kind Property": Condominium for an apartment complex, bare land for improved property, office building for retail center. Any property held for either business or investment purposes.

After identification has been made, Security Trust, by using the sale proceeds, purchases the replacement property, and subsequently transfers the replacement property to the Exchanger.

What is involved in a Deferred Exchange?
A typical tax deferred exchange is very similar to a taxable transaction except that prior to closing on the property being sold, a qualified intermediary is assigned into the Sale Contract. They sell the property to the buyer and transfer the proceeds safely into a separate exchange account. (The IRS stipulates the exchangee cannot be in actual or constructive receipt of funds at any time during the exchange.) The exchange period beings with the transfer of the first property providing the investor 45 days to identify, and a total of 180 days to close, on like-kind replacement property. The exchange is completed when the qualified intermediary is assigned into the Purchase Contract, utilizes the proceeds received to acquire the replacement property and instructs the closer to transfer ownership to the exchanger via direct deeding.

What are the Exchange Requirements?

- Purchase equal or greater value
- Reinvest all Net Equity
- Equal of greater debt (excretion: a reduction in debt can be offset with additional case, however a reduction in equity cannot be offset by increasing debt.)

Exchanges must be completed within strict time limits with absolutely no extensions. The Exchanger has 45 days from the date the relinquished property closes to identify potential replacement properties. This involves written notification to the Qualified Intermediary listing the addresses or legal descriptions. Purchase of the replacement property must be completed within 180 days after the close of the relinquished property. After the 45 days have passed, the Exchanger may not change their Property Identification list and much purchase one of the listed replacement properties or the exchange fails!

To avoid the payment of capital gain taxes, the Exchanger should follow three general rules: (1) Purchase a replacement property that is the same of greater value as the relinquished property, (2) Reinvest all of the exchange equity into the replacement property and (3) Obtain the same or greater debt on the replacement property as on the relinquished property. The Exchanger can offset the amount of debt obtained on the replacement property by putting the equivalent amount of additional cash into the exchange.

In the case of real property exchanges, the Exchanger must sell the property that is held for income or investment purposes and acquire replacement property that will be held for income or investment purposes. This is the like-kind property test. I.R.C. Section 1031 does not apply to exchanges of stock in trade, inventory, property held for sale, stocks, bonds or notes.

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Understanding the 1031 Exchange: Part 2 Investor Guidelines

Many people have the idea that 1031 exchanges are complicated, with extremely complex rules and requirements that must be met. While the rules are different from what taxpayers are accustomed to seeing in other areas of the law, there really is a simple, easy to follow logic to them.

Most of you remember the old "roll-over" law (which was repealed a couple of years ago) dealing with the sale of you personal residence. As you will recall, when you sold your old house, you had 2 years to buy a new house and as long as you bought equal or up, the gain rolled over from the old house to the new. That was Section 1034. Section 1031 sits right next to it in the Internal Revenue Code, and does the same thing for investment property that Section 1034 did from personal residences, i.e. the gain rolls over from the old property to the new.

There are six differences between old Section 1034 and Section 1031 that you need to be aware of when you consider a 1031 exchange:

1. Both your "old" property and your "new" property have to be investment property. Rental property, bare land or vacation homes are examples of investment property. If you meet this criteria, you can sell any type of property-say an apartment building- and buy any other type of property-say an office building.

2. from the date of closing on the sale of your old property, you have 45 days to generate a list of properties you would like to buy. This is called your "45 day list" and should contain at least 2 or 3 potential properties.

3. From the date of closing, you have 180 days to close th purchase of whatever property you are buying, and what you buy must be a listed property on your 45-day list.

4. You can not touch the money. By law, the money must be held by a "Qualified Intermediary," sometimes called an "Accommodator" or a "Facilitator," who is also responsible for the preparation or paper work required by the IRS to document the exchange.

5. Title has to stay the same. Whoever held title to the old property must retain title to the new property.

6. You must reinvest all of your cash, and your new property must be at least equal to the net sales price of the old property. If not, you pay tax on the difference.

As you can see, the 1031 Exchange rules closely resemble the old residential rollover rules, making them easy to remember and understand. Follow these simple rules and you will benefit from one of the last loopholes in the tax code.

Gary Gorman is the manager and co-owner of Professional Exchange Accommodators, LLC. He has 25 years of experience as a certified Public Accountant. Gary now handledd 1031 exchanges for clients and is a frequent writer and lecturer on the nation's largest Qualified Intermediary firms with Florida offices in Naples and Tampa (800-895-3532).

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