



Section 1031 Exchange

Definition

Let's begin by outlining the basics of Section 1031 Exchange...

What Is Section 1031 Exchange?

Introduced by Section 1031 of the Internal Revenue Code, this type of exchange allows investors to defer the tax on capital gains until some point in the future.

A tax-deferred exchange is a method by which a property owner trades one or more relinquished properties for one or more replacement properties of "like-kind," while deferring the payment of federal income taxes and some state taxes related to the transaction.

Section 1031 of the Internal Revenue Code provides that no gain or loss shall be recognized on the exchange of property held for productive use in a trade or business, or for investment.

The theory behind Section 1031 is that when a property owner has reinvested the sale proceeds into another property, the economic gain has not been realized in a way that generates funds to pay any tax. Essentially, the taxpayer's investment remains the same, only the form has changed (e.g. vacant land exchanged for apartment building).

The like-kind exchange under Section 1031 is tax-deferred, not tax-free. When the replacement property is eventually sold, the original deferred gain (plus any additional gain realized since the purchase of the replacement property) is subject to tax.

Always consult a competent Qualified Intermediary, attorney, or tax advisor to determine how an exchange may best be structured to accomplish your investment goals.



Section 1031 Exchange

Basic Concepts Explained

Exchange v. Sale

A Section 1031 Exchange is one of the few techniques available to postpone taxes due on the sale of qualifying properties. By deferring the tax, the investor has more money available to invest in another property.

Types of Exchanges

Simultaneous Exchange The exchange of the relinquished property for the replacement property occurs at the same time.

Delayed Exchange occurs when there is a time gap between the transfer of the relinquished property and the acquisition of the replacement property. This type of exchange is subject to strict time limits, which are set forth in the Treasury Regulations.

Build-to-Suit (Improvement or Construction) Exchange The taxpayer is allowed to build on, or make improvements to, the replacement property, using the exchange proceeds.

Reverse Exchange Replacement property is acquired prior to transferring the relinquished property.

Personal Property Exchange Exchanges are not limited to real property. Personal property can also be exchanged for other personal property of like-kind or like-class.

Requirements

Qualifying Property Certain types of property are specifically excluded from Section 1031: property held primarily for sale; inventories; stocks, bonds or notes; other securities or evidences of indebtedness; interests in a partnership; certificates of trusts or beneficial interest; and choses in action. In general, if property is not specifically excluded, it can qualify for tax-deferred treatment.



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Exchange **Basic Concepts Explained**

Types of Exchanges

Proper Purpose Both the relinquished property and replacement property must be held for productive use in a trade or business or for investment. Property acquired for immediate resale will not qualify. The taxpayer's personal residence will not qualify.

Like Kind Replacement property acquired in an exchange must be "like-kind" to the property being relinquished. All qualifying real property located in the United States is like-kind. Personal property that is relinquished must be either like-kind or like-class to the personal property which is acquired. Property located outside the United States is not like-kind to property located in the United States.

Exchange Requirement The relinquished property must be exchanged for other property, rather than sold for cash and using the proceeds to buy the replacement property. Most deferred exchanges are facilitated by Qualified Intermediaries, who assist the taxpayer in meeting the requirements of Section 1031.

Qualified Intermediary Defined

A Qualified Intermediary is an independent party who facilitates tax-deferred Section 1031 exchanges. Acting under a written agreement with the taxpayer, the QI acquires the relinquished property and transfers it to the buyer. The QI holds the sales proceeds, to prevent the taxpayer from having actual or constructive receipt of the funds. Finally, the QI acquires the replacement property and transfers it to the taxpayer to complete the exchange.

Can the taxpayer just sell the relinquished property and put the money in a separate bank account, only to be used for the purchase of the replacement property?

In short - no. The taxpayer may not receive the proceeds or take constructive receipt of the funds in any way, without disqualifying the exchange.



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Basic Concepts Explained

Time Restrictions

A taxpayer has 45 days after the date that the relinquished property is transferred to properly identify potential replacement properties. The exchange must be completed by the date that is 180 days after the transfer of the relinquished property, or the due date of the taxpayer's federal tax return for the year in which the relinquished property was transferred, whichever is earlier. In fact, for a calendar year taxpayer, the exchange period may be cut short for any exchange that begins after October 17th.

Limitation on Number of Properties that Can Be Identified

There are three rules that limit the number of properties that can be identified. The taxpayer must meet the requirements of at least one of these rules:

3-Property Rule The taxpayer may identify up to 3 potential replacement properties, without regard to their value, or

200% Rule Any number of properties may be identified, but their total value cannot exceed twice the value of the relinquished property, or

95% Rule The taxpayer may identify as many properties as he wants, but before the end of the exchange period the taxpayer must acquire replacement properties with an aggregate fair market value equal to at least 95% of the aggregate fair market value of all the identified properties.

Requirements to Properly Identify Replacement Property

Importantly, the identification cannot be made orally. Potential replacement property must be identified in a writing, signed by the taxpayer, and delivered to a party to the exchange who is not considered a "disqualified person." A "disqualified" person is any one who has a relationship with the taxpayer that is so close that the person is presumed to be under the control of the taxpayer. Examples include blood relatives, taxpayer's attorney, accountant, investment banker or real estate agent.