1031 Exchange – The Basics

What is a 1031 exchange?

- Under section **1031** of the Internal Revenue Code, a real property owner can sell his property and then reinvest the proceeds in ownership of like-kind property and defer the capital gains taxes. To qualify as a like-kind exchange, property exchanges must be done in accordance with the rules set forth in the tax code and in the treasury regulations. The 1031 exchange can offer significant tax advantages to real estate buyers. Often overlooked, a 1031 exchange is considered one of the best-kept secrets in the Internal Revenue Code.

Who should consider a 1031 exchange?

- If you have real property that will net you a gain upon sale (generally property that has been substantially depreciated for tax purposes and/or has appreciated in fair market value), then you are exactly the person who should consider a 1031 exchange.

  There are five (5) tax classes of property:
  1) Property used in taxpayer's trade or business.
  2) Property held primarily for sale to customers.
  3) Property which is used as your principal residence.
  4) Property held for investment.
  5) Property used as a vacation home.

  Section 1031 applies to the first and fourth categories, and potentially the fifth category. Business use is defined as, "To hold property for productive use in trade or business." Property retired from previous productive use in business can be qualifying property. Investment purpose defined as real estate, even if unproductive, held by a non-dealer for future use or increment in value is held for investment and not primarily for sale. Investment is the passive holding of property, for more than a temporary period, with the expectation that it will appreciate. Property held for sale in the immediate future is not held for investment.

Why should you consider a 1031 exchange?

- Defer paying capital gains taxes.
- Leverage.
- A properly structured exchange can provide real estate investors with the opportunity to defer all of their capital gains taxes. By exchanging, the investor essentially receives an interest-free, no-term loan from the government.
- Relief from property management. The lessee takes the responsibility to sublet and maintain the property allowing real estate buyers to avoid most of the day-to-day management headaches.
- Upgrade or consolidate property.
- Diversify. Own multiple properties rather than just one.
- Relocation to a new area.

- Differences in regional growth or income potential.
- Change property types among residential, commercial, retail, etc.

What are the 1031 exchange rules?

- The real property you sell and the real property you buy must both be held for productive use in a trade or business or for investment purposes and must be like-kind.
- The proceeds from the sale must go through the hands of a qualified intermediary and not through your hands or the hands of one of your agents or else all the proceeds will become taxable.
- All the cash proceeds from the original sale must be reinvested in the replacement property - any cash proceeds that you retain will be taxable.
- The replacement property must be subject to an equal level or greater level of debt than the relinquished property or the buyer will either have to pay taxes on the amount of the decrease or have to put in additional cash funds to offset the lower level of debt in the replacement property.

1031 Timelines

1. **Identification Period:** Within 45 days of selling the relinquished property you must identify suitable replacement properties. This 45 day rule is very strict and is not extended should the 45th day fall on a Saturday, Sunday, or legal holiday.

2. **Exchange Period:** The replacement property must be received by the taxpayer within the "exchange period", which ends within the earlier of . . . 180 days after the date on which the taxpayer transfers the property relinquished, or . . . the due date for the taxpayer tax return for the taxable year in which the transfer of the relinquished property occurs. This 180-day rule is very strict and is not extended if the 180th day should happen to fall on a Saturday, Sunday or legal holiday.

Replacement property identification

✓ **3-property rule:** You may identify any three properties as possible replacements for your relinquished property. More than 95% of exchanges use the 3-property rule.

or

✓ **200% rule:** You may identify any number of properties as possible replacements for your relinquished property as long as the aggregate value of those properties does not exceed 200% of the value of your relinquished property.

or

✓ **95% exemption:** You may identify any number of properties as possible replacements for your relinquished property as long as you end up purchasing at least 95% of the aggregate value of all properties identified.

Like-Kind Property

- In a 1031 exchange you can exchange any real property for any other real property within the United States or its possessions if said properties are held for productive use in trade or business or for investment purposes. Examples of like-kind property include apartments, commercial, condos, duplexes, raw land and rental homes*. As used in IRC **1031**(a), the words "like-kind" mean similar in nature or character, notwithstanding differences in grade or quality. One kind of class of property may not, under that section, be exchanged for property of a different kind or class. Examples of qualified like-kind exchanges:

    - apartment building for farm/ranch

- office building for hotel
- raw land for retail space
- unimproved property for commercial property
- airplane for airplane

Examples of non like-kind properties include primary residences, stocks and bonds, notes, partnership interests, developed lots held primarily for sale and property to be resold immediately after initial purchase or completion of improvements.

* Qualification for Section 1031 exchanges depends upon the extent of personal use.
1031 exchange formats:

- Simultaneous
  - Two-party swap
  - Alderson exchange
- Delayed exchange (most common)
  - Safe Harbor
- Multiple sales/acquisitions
- Reverse exchange
- Improvement exchange

History of 1031 exchange

1918 - First income tax law
1921 - Section 202 of Internal Revenue Code states that gain or loss not recognized on exchanges of like-kind property
1924 - Non like-kind exchanges excluded from Section 202
1928 - Code section changed to Section 112(b)(1)
1954 - Section 1031 enacted
1975 - Starker exchange; Tax court approves delayed exchange
1977 - Tax court reverses prior ruling, invalidating delayed exchanges
1979 - 9th Circuit reverses, reinstating initial ruling and creating delayed exchange
1984 - Congress amends Section 1031; 45 day identification period and 180 day exchange period and partnerships excluded
1991 - Regulations 1.1031 passed
2002 - Revenue Procedure 2002-22 issued by IRS; 15 points to clarify TIC interes

The role of the Qualified Intermediary (QI)

The QI is a person or entity that can legally hold funds to facilitate a 1031 exchange. To be qualified, the intermediary must not be a relative or agent of the exchanging party. As an exception, a real estate agent may serve as an intermediary if the current transaction is the only instance in which the agent has represented the exchanging party over the past two years.

The use of a QI is essential to completing a successful 1031 exchange. The QI performs several important functions in the 1031 exchange process including creating the exchange of properties, holding the exchange proceeds, and preparing the legal documents.