an introduction to 1031 Deferred Exchanges

a Powerful Tax Strategy

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Exchanges are a Powerful Tax Strategy

IRC 1031 tax deferred exchanges continue to increase in popularity throughout Colorado and the United States as more investors discover this powerful technique as one of the most effective ways to accumulate wealth in real estate. Tax deferred exchanges have been a part of the tax code since 1921 and are one of the last significant tax advantages remaining for real estate investors. One of the key advantages of a §1031 exchange is the ability to sell a property without incurring a capital gain tax liability, thereby allowing the earning power of the deferred taxes to work for the benefit of the investor (Exchanger) instead of the government. In essence, it can be considered an interest-free loan from the IRS.

Basic Tax Deferred Exchange Requirements

Although many investors mistakenly believe an exchange is simply a "swap" of properties, most exchanges completed are variations of what is called a "delayed" exchange. In a delayed exchange under Section 1031, the property currently owned is called the "relinquished" property and must be exchanged for like-kind "replacement" property. The replacement property must be of equal or greater value to the relinquished property. The IRS allows up to 180 days between the sale of the relinquished property and the purchase of the replacement property. There are a number of requirements which need to be met to qualify for tax deferral under the tax code:

Requirement #1: Both the "relinquished" and "replacement" properties must be held for investment or used in a business only. The IRS uses the term "like-kind" to describe the type of properties that qualify. An investor's primary residence can not be utilized as part of a tax deferred exchange. Any property held for investment can be exchanged for any other "like-kind" property held for investment. This definition covers a vast variety of developed and undeveloped real estate. The relinquished and replacement properties need not have identical functions (i.e. residential rentals for commercial centers), however, both properties must be for investment purposes.

Requirement #2: The IRS requires an investor to identify the replacement property(s) within 45 days from closing on the sale of a relinquished property. The 45 Day Identification Period begins on the closing date, and the replacement property(s) must be properly identified in a letter signed by the Exchanger and received by the Qualified Intermediary.

The IRS requires the use of a Qualified Intermediary as a third party facilitator of the delayed exchange. A Qualified Intermediary can be any individual or entity that does not have a direct interest, or relation to any party, in the transaction.

Exchangers have a number of ways to properly identify properties. The two most common are the "Three Property Rule" and the "200% Rule". An exchanger may identify up to three replacement properties without regard to their total fair market value (Three Property Rule). Alternatively, they can identify an unlimited number of replacement properties, if the total fair market value of all properties is not more than twice the value of the property sold (200% Rule).

Requirement #3: Close on the replacement property by the earliest of either: 180 calendar days after closing on the sale of the relinquished property or the due date for filing the tax return for the year in which the relinquished property was sold (unless an automatic filing-extension has been obtained). Example: If an Exchanger closes on the relinquished property on December 27, the 180 day period will end after April 15 (Tax Day). In this case, they would have to close on the replacement property (or request an extension of time to file their taxes) by April 15. Exchangers may choose to close both transactions within a shorter period of time, thereby avoiding the potential hardship of the 45/180 day time limits.

Requirement #4: The most common exchange format, the delayed exchange, requires investors to work with a Qualified Intermediary. The Qualified Intermediary actually documents the exchange by preparing the necessary paperwork (Exchange Agreements), holding proceeds on behalf of the Exchanger, and structuring the sale of the relinquished property and purchase of the replacement property.

NOTE: To defer all capital gains taxes, an Exchanger must buy a property or properties of equal or greater value (net of closing costs), reinvesting all net proceeds from the sale of the relinquished property. Any funds not reinvested, or any reduction in debt liabilities not made up for with additional cash from the Exchanger, is considered "boot" and is taxable. Example: Stewart sells his duplex, which he held for investment, for $160,000. A hundred days later he closes on a different duplex, which he will hold for investment, for $110,000. Stewart banks the $50,000 in excess funds for his child's education. Stewart must pay capital gain taxes on $50,000. (In this example, Stewart chose to take some money out of his exchange and pay the tax.)

1031 exchanges offer a wide array of options to investors. Contact your legal/ tax advisor and an experienced Qualified Intermediary to learn more about this tremendous tax strategy.

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