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What is a 1031 Exchange?

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 of the equity to acquire replacement investment property, defer the capital gain tax that would ordinarily be paid, and leverage all of their equity into the replacement property.

Two requirements must be met to defer the capital gain tax:

- (a) the Exchanger must acquire like-kind replacement property and
- (b) the Exchanger cannot receive cash or other benefits (unless the Exchanger pays capital gain taxes on this money).

The tax code states

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.

“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 if such property is exchanged solely for property of a like-kind which is to be held for either productive use in trade or business or for investment purposes.”

What is Involved in a Delayed 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 exchanger cannot be in actual or constructive receipt of funds at any time during the exchange.)

The exchange period begins 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 deed.

What are the Exchange Requirements?

- Purchase Equal or Greater Value
- Reinvest all Net Equity
- Equal or greater debt. (Exception: A reduction in debt can be offset with additional cash, 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 a written notification to the Qualified Intermediary listing the addresses or legal descriptions of the potential replacement properties. The purchase of the replacement property must be completed within 180 days after of the close of the relinquished property. After the 45 days has passed, the Exchanger may not change their Property Identification list and must 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: (a) purchase a replacement property that is the same or greater value as the relinquished property, (b) reinvest all of the exchange equity into the replacement property, and (c) 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 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, notes, securities, evidences of indebtedness, certificates of trust or beneficial interests or interests in a partnership.

Have more questions about your escrow? Please contact us for answers. And remember to always **insist on Fidelity National Title.**