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1031 Tax Exchanges

How familiar are you with Code Section 1031? It is one of the oldest and most unique savings vehicles built into the tax code. Real Estate Investing is definitely a friend of Congress because it shares many tax benefits that other investments do not, including 1031 Exchanges.

WHAT IS 1031? A 1031 is designed for investment properties to be “exchanged or traded” with little or no tax due if the rules are followed. In other words, if you sell investment real estate all taxes including Capital Gains, Recapture Taxes and State Taxes can be deferred. The taxes are deferred or rolled to the next property, giving the Exchangor additional buying power. Also, by deferring these taxes, you are basically getting an interest free loan from the IRS. You cannot beat that.

WHAT ARE THE RULES?

1. You must use a Qualified Intermediary to facilitate the exchange. In a 1031, two individuals typically do not swap properties. The Exchangor, or Seller, can sell to whoever he likes and purchase from whoever he likes. The role of the QI is ownership of the properties via Assignment not through directed deed. The QI will also escrow the sales proceeds. One of the key elements of any exchange is that Exchangor never have constructive receipt of the sale funds.
2. Timing Rules—If the Exchangor has not identified a replacement property, he or she has 45 days from the date of sale to identify up to three replacement properties. If they would like to identify more than 3 properties, the value of the replacement properties cannot exceed 200% of the gross relinquished property sales price. The other timing rule is once replacement properties have been identified, you must take title on all properties within 180 days of closing on the sale of the relinquished properties. The timing rules are actually very good for moving the transaction along.

3. Net Selling Price (NSP)—one of the most confusing aspects of 1031 is that the Exchangor must buy replacement property that is equal to or of greater value than the relinquished property to avoid all tax. Typically, if you purchase for more than your NSP (Gross Sales Price less closing costs), all taxes will be deferred.

WHAT PROPERTY QUALIFIES FOR 1031 EXCHANGE?

Typically for a property to qualify, it must be held for business or investment purposes. That means that personal real estate will not qualify, specifically, a first or second home. The following types of real estate do qualify for exchange if they are held for business use or held as investment property.

- **Rental Property including**
 - **Single family homes**
 - **Condominiums**
 - **Multifamily including duplexes and triplexes**
 - **Commercial Real Estate**
 - **Farm Land**
- **Owner Occupied for Business**
- **Tenants in Common Interest**
- **Raw Land**
- **Oil and Gas Deeds**

Vacation Properties can qualify for 1031 Exchange treatment if held for rental two years prior to and after the exchange, and personal use cannot exceed 10 days or 10% of days rented (Revenue Procedure 2008-16).

REVERSE EXCHANGES—Usually in a 1031 Exchange, you sell first and then buy. Sometimes it becomes necessary for taxpayer to purchase the replacement property before selling the Relinquished Property. There is a technique approved by the IRS called a Reverse Exchange (Revenue Procedure 2000-37). In this arrangement, the QI is hired to purchase the replacement property on behalf of the Exchangor. The QI becomes a title holder for up to 180 days. The entire reverse exchange must be completed in this time frame. With a Reverse Exchange the Exchangor will still finance or pay for the Replacement Property.

WHY EXCHANGE?

There are various reasons why people exchange property. Do any of these reasons match your situation?

1. You have appreciated Property with capital tax due upon sale
2. Consolidating Assets—With a 1031 you are allowed to sell multiple properties and consolidate into one more efficient property.
3. Create a pyramiding effect—By continuing to perform a 1031, you can substantially build your real estate portfolio.

THE KEY TO A GOOD 1031

What is your intent with that property? How long are you going to hold it? There is no set holding period with 1031 properties but properties held as inventory or resale (flippers) do not qualify for 1031. Real Estate is typically held long term, and if rented or used in a business, will usually always qualify for tax deferral if the replacement property is of greater value. **NOTE:** *If your relinquished property has debt, it is expected that your replacement property will also have similar or greater debt to avoid all taxes.*

WEALTH TIP: The goal with any investment is to build long term wealth. A 1031 Exchange can allow a taxpayer to use a long term asset like real estate to continually build and improve their portfolio. No other asset has the benefits of 1031, which allows you to sell and not have to immediately pay the taxes. Take advantage of 1031.