

1031 Exchange (Deferred Exchange)

By doing a 1031 Exchange, a tax payer may dispose of “property held for productive use in trade or business or for investment” (which we’ll call investment property), and acquire replacement investment property without recognition of capital gain in calculating the taxpayer’s income tax. By avoiding the recognition of capital gain, the taxpayer defers payment of income taxes without any penalty or interest coming due to the IRS or state authorities.

There are strict compliance rules in the 1031 exchange which, if not followed, could have serious tax implications. The first rule is that in order for both properties to qualify in the exchange they must be of “like kind” and both properties must be held for a productive purpose in business or trade, such as an investment. The second fundamental rule is that replacement property must be subject to an equal or greater level of debt than the relinquished property. If not, the buyer will be forced to pay taxes on the amount of the decrease.

The proceeds from the sale must go through a “qualified intermediary” and cannot go through your hands or the hands of one of your agents, otherwise the proceeds will become taxable. The entire cash or monetary proceeds from the original sale has to be reinvested towards acquiring the new real estate property. Any cash proceeds retained from the sale are taxable.

There are two very important time sensitive rules to be aware of. The first is the identification period. This is the important period during which the party selling a property must identify the replacement properties that they wish to buy. It is not uncommon to select more than one. This period is scheduled as exactly 45 days from the date of sale of the relinquished property. This 45 days timeline cannot be extended under any circumstances. The 45 days also includes weekend days and holidays.

The other important time-related rule is the Exchange Period. This is the period within which a person who has sold the relinquished property must receive the replacement property. This period ends at exactly 180 days after the date of sale of the relinquished property or the due date (including extensions) for the person’s tax return for the year in which the property was relinquished, whichever is earlier. The 180 day rule is non-negotiable with one exception: the property being acquired is unimproved or under construction.

As with any investment, it is suggested you speak to your tax attorney or tax preparer to further discuss legal and monetary advantages and disadvantages.

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