



# How to Do 1031 Exchanges

## The Definition of Like-Kind Properties Has Changed Over the Years

The time-worn saying, "Nothing is certain but death and taxes," is only half true for a savvy American taxpayer who is planning the sale of an investment or business property. Since [capital gains tax](#) on your profits could run as high as 15% to 30% when state and federal taxes are combined, why not take the necessary steps to avoid this loss? A big tax bite could wipe out money you need for future investments.

### 1031 Exchanges Defer Taxes

The 1031 Exchange has been cited as the most powerful wealth building tool still available to taxpayers. It has been a major part of the success strategy of countless financial wizards and real estate gurus. Taking its name from Section 1031 of the Internal Revenue Code, a tax-deferred exchange allows a taxpayer to sell income, investment or business property and replace it with a [like-kind](#) property.

Capital gains on the sale of this property are deferred or postponed as long as the IRS rules are meticulously followed. This is a wise tax and investment strategy as well as an estate planning tool. In theory, an investor could continue deferring capital gains on investment property until death, potentially avoiding them all together.

### 1984 Legislation Changed Some Aspects of 1031 Exchanges

In the early days of "like-kind exchanges," the term was taken quite literally and often posed difficulties. For instance, if you owned a three-story brick apartment building that you wanted to sell through a 1031 exchange, you would have to find another three-story brick apartment building whose owner wanted to swap. Then the two of you would meet and the exchange would take place.

In the past, there were no time constraints on the exchange. The IRS demanded stricter controls on the process, which resulted in Congress passing in 1984 Section 1031(a). This legislation limited deferred exchanges, further defined "like-kind" property and established a time table for completing the exchange.

### Qualifying for a 1031 Exchange

Real estate property held for business use or investment qualifies for a 1031 Exchange. A personal residence does not qualify and, generally, a [fix-and-flip](#) property also doesn't qualify because it fits in the category of property being held for sale. Vacation or second homes, which are not held as rentals do not qualify for 1031 treatment; however, there is a usage test under Paragraph 280 of the tax code that may apply to those properties. A tax expert should be consulted in this case.

Land, which is under development, and property purchased for resale do not qualify for tax-deferred treatment. Stocks, bonds, notes, inventory property, and a beneficial interest in a partnership are not considered "like-kind" property for exchange purposes.

To qualify as a 1031 exchange today, the transaction must take the form of an "exchange" rather than just a sale of one property with the subsequent purchase of another. First, the property being sold and the new replacement property must both be held for investment purposes or for productive use in a trade or a business. They must be "like-kind" properties.

The following types of real estate swaps fit the requirement for a qualified exchange of "like-kind" property:

- An office in exchange for a shopping center
- A shopping center in exchange for land
- Land in exchange for an industrial building
- An apartment building in exchange for an industrial building
- A single family rental in [exchange for a tenants in common](#) (TIC) property

Today, you could exchange that brick apartment building for raw land, a warehouse, or a small office building. However, there are strict time constraints which must be met or the 1031 Exchange will not be allowed and tax consequences will be imposed.

Prior to 1984, virtually all exchanges were done simultaneously with the closing and transfer of the sold property, (Relinquished Property), and the purchase of the new real estate, (Replacement Property). In addition to the problems encountered when trying to finding a suitable

property, there were difficulties with the simultaneous transfer of titles as well as funds.

The delayed 1031 Exchange avoids those pre-1984 problems but stricter deadlines are now imposed. A taxpayer who wants to complete an exchange, lists and markets property in the usual manner. When a buyer steps forward and the [purchase contract](#) is executed, the seller enters into an exchange agreement with a Qualified Intermediary who, in turn, become the substitute seller. The exchange agreement usually calls for an assignment of the seller's contract to the Intermediary. The closing takes place and, because the seller cannot touch the money, the Intermediary receives the proceeds due the seller.

### 1031 Exchanges Carry Time Restrictions

At that point, the first timing restriction, the 45-Day Rule for Identification, begins. The taxpayer must either close on or identify in writing a potential Replacement Property within 45 days from the closing and transfer of the original property. The time period is not negotiable, includes weekends and holidays, and the IRS will not make exceptions. If you exceed the time limit, your entire exchange can be disqualified and taxes are sure to follow.

Types of Replacement Properties to Identify:

1. Three properties without regard to their [fair market value](#).
2. Any number of properties as long as their aggregate fair market value at the end of the identification period does not exceed 200% of the aggregate fair market value of the relinquished property as of the transfer date.
3. If the three-property rule and the 200% rule is exceeded, the exchange will not fail if the taxpayer purchases 95% of the aggregate fair market value of all identified properties.

### What is Boot?

Realistically, most investors follow the three-property rule so they can complete due diligence and select the one that works best for them that will close. Generally, the goal is to trade up to avoid the transfer of "boot" and keep the exchange tax-free.

"Boot" is the money or fair market value of any additional property received by the taxpayer through the exchange. Money includes all cash equivalents, debts, liabilities to which the exchanged property is subject. This is "non-like-kind" property and the rules governing it during the exchange are complex. Suffice it to say, without expert advice, receiving "boot" can result in taxes.

### 1031 Exchanges are Subject to the 180-Day Rule

Once a replacement property is selected, the taxpayer has 180 days from the date the Relinquished Property was transferred to the buyer to close on the new Replacement Property. However, if the due date on the investor's tax return, with any extensions, for the tax year in which the Relinquished Property was sold is earlier than the 180-day period, then the exchange must be completed by that earlier date. Remember, a portion of this period has already been used during the Identification Period. There are no extensions and no exceptions to this rule, so it is advisable to schedule the closing prior to the deadline.

Since the law requires that the taxpayer not touch the proceeds from the first transaction, the Qualified Intermediary acquires the Replacement Property from the seller at closing and after the transaction is completed, then transfers it to the taxpayer.

### 1031 Exchanges Are Not For Do-It-Yourself Investors

This is a basic description of how a successful 1031 Exchange works. Depending upon the taxpayer's situation, the type of property relinquished and the characteristics of the Replacement Property, other aspects of the Exchange may be involved. Its completion may become complex and experts should always be consulted. This is no task for a "do it yourself" investor.

Using the power of the 1031 Exchange to build and preserve wealth and assets, generate cash flow from investments, restructure, diversify and consolidate real estate holdings is the right of every owner of investment property in the United States. American taxpayers should never have to pay capital gains taxes on the sale of their investment property if they intend to reinvest those proceeds in more investment property. *Securities offered through Pacific West Securities, Inc. Member FINRA/SIPC.*

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