

1031 Tax Deferred Exchange Basics

The sale, disposition or conversion of investment real estate may result in the recognition of ordinary income, depreciation recapture and/or capital gain income tax liabilities, so it is important for the investor to be familiar with the various tax-deferral and tax-exclusion strategies available.

The 1031 exchange allows an investor to sell their existing property (*relinquished property*) held for rental, investment or productive use in a trade or business and purchase other like-kind property (*replacement property*) to be held for rental, investment or productive use in a trade for business in order to defer their Federal, and in most cases, State income taxes.

Below are some of the basic rules to follow when considering a 1031 exchange:

Requirements:

- The investor must have held the relinquished property for rental, investment or use in a business, and must have the **intent to hold** the replacement property for rental, investment or use in their business.
- The relinquished and replacement properties must be of like-kind in order to qualify for 1031 exchange treatment.
- The investor must acquire replacement property that is equal to or greater in value than the relinquished property (based on net sales price) to defer 100% of capital gain.
- Must reinvest all of the net proceeds (net equity) from the sale of the relinquished property into the replacement property to defer 100% of capital gain.
- Must replace the outstanding debt or mortgage value on the relinquished property with new debt on the replacement property, although the Investor may elect to replace the debt with an additional cash contribution instead to defer 100% of capital gain.
- A **Qualified Intermediary**, otherwise referred to as the *Accommodator or Facilitator* must be selected in order to qualify for a 1031 exchange.
- Only Domestic (US) property can be exchanged for domestic property and only non-domestic (foreign) property can be exchanged for non-domestic property. Domestic property *can not* be exchanged for non-domestic property.
- Certain types of properties are specifically **excluded as like-kind**. Some of these properties include those held for personal use such as a primary residence, second home or vacation home, as well as cash, stocks, bonds, notes real estate investment trust interests (REITS), and partnership interests.

Exchange Deadlines:

- The investor has **45 calendar days** from the close of their sale transaction, defined as the transfer or conveyance of the title to his relinquished property to the buyer, to **identify** potential replacement property (ies) to be acquired as part of the 1031 exchange transaction. There is no exception to this 45 day rule.
- The investor may identify up to *three properties* in order to have back up properties identified in case the first choice cannot be acquired, **OR** the investor may identify more than three potential replacement properties as long as the total fair market value of all the potential replacement properties identified does not exceed **200%** of the sales price of the relinquished property (ies).
- The investor must complete the acquisition of one or more of their identified replacement property(ies) no later than either (1) **180 calendar days** from the close of his sale transaction, OR (2) by the due date (including extensions) of his Federal income tax return.

If you are considering a 1031 Tax-Deferred Exchange, please consult with your tax advisor regarding your specific situation and how the deferred exchange can work for you.