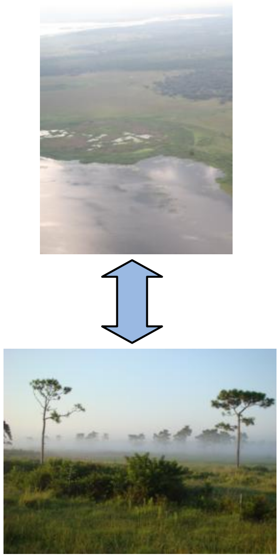
1031 TAX-DEFERRED REAL ESTATE EXCHANGES



What is a 1031 Tax-deferred Real Estate Exchange?

In a typical real estate transaction, a seller is taxed on any gain realized from the sale of a property. By doing a **1031 exchange** an owner may sell one qualified property and acquire another qualified property within a specific time frame and receive a tax deferral on any capital gains. The properties exchanged must be of a "like-kind" or of the same nature or character, even if they differ in grade or quality. The logistics and process of a 1031 exchange are almost identical to a standard real estate sale, but the transaction is unique because it is treated as an *exchange* of properties and not as a simple sale. In the exchange, the seller qualifies for a deferred capital gains tax treatment, where in a sale he does not. The rules for a tax-deferred 1031 exchange are defined in the 1031 section of the Internal Revenue Code. It is best to consult with an attorney and/or a tax professional when considering a 1031 exchange.

What are the Benefits of a 1031 Exchange?

- A 1031 exchange is one of the most powerful tax deferral strategies for taxpayers who wish to sell real estate. It can postpone or potentially eliminate taxes due on the sale of qualifying properties. While a 1031 exchange defers taxes, it does not eliminate them so all records of the original sale/exchange should be maintained.
- By deferring the tax, the seller has more money available to invest in another property. In effect, it is like receiving an interest free loan from the federal government for the amount that the seller would have paid in taxes.
- Any gain from depreciation recapture is postponed.
- You can acquire and dispose of properties to reallocate your investment portfolio without paying tax on any gain.

What Properties are Eligible for Exchange?

- The replacement property cannot be real estate for personal use. It must be used in **trade** or **business** or as an **investment**. However, a home that may be considered investment real estate today may have value as a personal residence in the future.
- As long as both the property to be sold and the property to be purchased are held for productive use in a trade or business, or for investment purposes, taxpayers are free to purchase whatever type of property they want. Based upon state law, some non-traditional interests in real property such as development rights, air rights and timber rights can also be exchanged in the process.

What Kinds of Exchanges are Allowed?

- Delayed Exchange: There is a gap between the time of transfer of the relinquished property and the time of acquisition of the replacement property. A *delayed exchange* is subject to strict time limits and is the most common type of exchange.
- Simultaneous Exchange: The exchange of the relinquished property for the replacement property occurs at the same time.
- Build-to-Suit (Improvement or Construction) Exchange: The seller will build on or make improvements to the replacement property using the exchange proceeds.
- Reverse Exchange: In a reverse exchange the replacement property is acquired prior to transferring the relinquished property. The IRS has offered a safe harbor for reverse exchanges as of September 5, 2000. These transactions may also be structured in ways outside the safe harbor.
- Personal Property Exchange: Exchanges are not limited to real property. Personal property can also be exchanged for other personal property of like-kind or like-class.

What are the Rules Associated with a 1031 Exchange?

There are two major rules associated with a 1031 exchange:

- The total purchase price of the replacement "like kind" property must be equal to, or greater than the total net sales price of the relinquished, real estate, property.
- All the equity received from the sale, of the relinquished real estate property, must be used to acquire the replacement, "like kind", property.

Other important constraints are:

- If replacement property is not acquired immediately, the sales proceeds must go to an escrow fund maintained by a qualified intermediary (defined explicitly by IRS rules) until the replacement property is acquired.
- There must be an actual purchase, generally within 180 days after the original property was transferred.
- Replacement properties must be identified within 45 days of the sale. The seller must identify up to three properties at fair market value or identify more properties providing their total fair market value is not more than twice the value of the relinquished property.
- The *value*, *equity* and *incurred debt* of the replacement property must be equal to or greater than the value of the relinquished property.
- An exchange may not produce total tax deferrals. If the adjusted value of the replacement property is less than the adjusted value of the relinquished property, there may be taxable profit.

Where Can I Find Out More about 1031 Exchanges?

- National Association of Realtors--http://www.realtor.org/library/library/fg408
- 1031 Exchange Made Simple--http://www.1031exchangemadesimple.com
- 1031 Corporation-- https://www.1031cpas.com