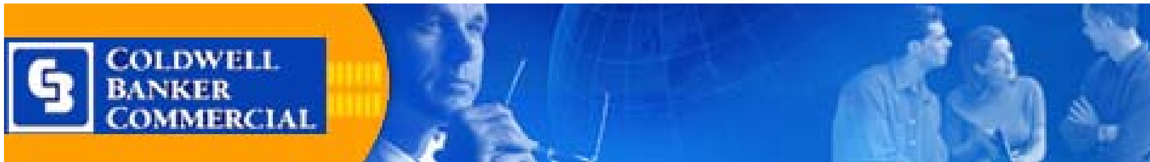

REVIEW OF 1031 EXCHANGE FUNDAMENTALS

Taxpayers planning to sell, purchase, or construct real property should review the possibility of conducting an Internal Revenue Code Section 1031 like-kind exchange to defer the incurrence of federal and general state income taxes on the capital gain. To qualify, property owners must exchange real or personal property (relinquished property) for other property of a like-kind (replacement property).

For example, John Smith owns an apartment building valued at $500,000. He wants to sell the building to purchase another investment property, but avoid incurring capital gains taxes. Following detailed IRC rules, he can accomplish this through a 1031 exchange.

Defining Like-Kind Property: The definition of like-kind real property is very broad; the replacement property does not have to be the same type as the relinquished property. For example, John could exchange his multifamily building for an office or retail property or for a tenancy-in-common or fee interest. Also, the replacement property is not limited to a single building; John could purchase a portfolio of three small buildings. Not allowed are transfers of certain property inventory or other property held primarily for sale, such as subdivided lots held for sale, and interests in partnerships or REITs.

Use Requirements and Holding Period: Taxpayers must have held the relinquished property for use in a trade or business or for investment. Under this requirement, personal residences are not eligible. While no formal rule exists, the IRS historically has taken the position that the taxpayer must hold both the relinquished and replacement properties in a qualified use for a certain period of time. Thus, the IRS might challenge the exchange if John sold the replacement property shortly after the exchange.

Recognition of Gain or Loss: To defer total gain, both the value and net equity of the taxpayer's replacement property must equal or be greater than the value and net equity of the relinquished property at the time of the exchange. In John's case, the replacement property must have a value of at least $500,000 and the value must exceed by $300,000 (net equity) any debt assumed in connection with the replacement property.

If the value of the replacement property is less than $500,000 or the net equity is less than $300,000, John would be taxed on the greater of the trade down in value or equity, limited to the gain he would have recognized if the property simply had been sold for its fair market value.

The Qualified Intermediary: Most like-kind exchanges are deferred exchanges. To complete a deferred exchange, the taxpayer must transfer the relinquished property for other like-kind property and not for money. Therefore, the taxpayer cannot gain actual or constructive receipt of the relinquished property's proceeds before purchasing the qualifying replacement property. Tax regulations impose strict limitations on the taxpayer's access or control over the proceeds and expressly limit the right to receive, pledge, borrow, or otherwise obtain the benefits of the money.

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Thus, deferred exchanges require the use of a qualified intermediary to hold the sales proceeds and acquire the replacement property.

Deferred Exchange Timing: Strict timing rules apply to deferred exchanges. Generally, the taxpayer must identify the replacement property or properties in writing to the intermediary within 45 days of the relinquished property's sale. Within 180 days of the transfer of the relinquished property, the taxpayer must receive the replacement property. The 180-day period is limited to the due date of the taxpayer's tax return unless that return is extended.