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1031 Exchanges: What You Need to Know to Take Advantage

If you have a gain when selling property, IRC Section 1031 provides an exception, allowing you to postpone paying tax on the gain if you reinvest the proceeds in similar property as part of a qualifying like-kind exchange. Gain deferred in a like-kind exchange under IRC Section 1031 is tax-deferred, but it is not tax-free. As proposals to repeal Section 1031 exchange are in the works, real estate investors should take advantage of the current 1031 exchange rules before they become limited. In this article, we will explore what a like-kind exchange is, what the time limits are for this type of exchange and the need to use an intermediary in these deferrals, so you can take advantage of Section 1031.

Defining a Like-kind Exchange

Currently, Internal Revenue Service Code Section 1031 permits a taxpayer to exchange business use or investment assets for other like-kind business or investment assets without recognizing taxable gain on the sale of the old assets. Both the relinquished property you sell and the replacement property you buy must be similar enough to qualify as like-kind. Most real estate will generally be like-kind to other real estate. Certain property such as inventory, securities and investment in a partnership interest are specifically excluded from Section 1031 treatment.

Like-kind 1031 Exchange Time Limits

Starting from the date you sell the relinquished property you have 45 days to identify a replacement property and the earlier of 180 days, or the due date of your tax return to complete the exchange. Any missed deadlines will disqualify the entire exchange.

Structuring the Deferral

To structure a successful deferral of the gain there are three important factors you need to know:

1) The replacement property should be equal to or greater than the value of the relinquished property;
2) Reinvest the entire net equity in the replacement property;
3) The acquired debt on the replacement property is equal to or greater than debt on the relinquished property.

Finally, it is important to hire an intermediary to finalize the deferral. Most 1031 exchanges involve separate buyers and sellers, and are not simple swaps between two parties. The regulations require the use of a qualified exchange facilitator also known as Qualified Intermediary ("QI") to hold the sales proceeds and disburse funds through an escrow account.

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Before structuring a 1031 exchange it is important to consult your tax advisor and QI to minimize the tax impact. To fully understand the tax implications of your specific situation feel free to contact Alicia On, Senior Tax Manager at DZH Phillips, one of the largest accounting and advisory firms in the San Francisco Bay Area.

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