Intro to Delayed Exchanges

An Introduction to the Benefits of a 1031 Exchange

1031 Knowledge

1031 Exchanges are a Powerful Tax Strategy

Tax-deferred exchanges have been a part of the tax code since 1921 and are one of the last significant tax advantages remaining for business owners and taxpayers. One of the key advantages of a 1031 exchange is the ability to dispose of a relinquished property without incurring a capital gain tax liability in the current tax year, thereby allowing the earning power of the deferred taxes to work for the benefit of the taxpayer instead of the government.

Basic Tax Exchange Requirements

The IRS allows up to a maximum of 180 calendar days between the sale of the relinquished property and the purchase of the replacement property. Within the 180-day exchange period, the taxpayer must also properly identify suitable replacement property or properties by midnight of the 45th calendar day after closing on the sale of the relinquished property. There are a number of requirements which need to be met to qualify for tax deferral under the tax code:

Requirement #1: Both the relinquished and replacement property must be held for investment or used in a business. The IRS uses the term "like-kind" to describe the type of real property that qualify for §1031 tax deferral. Virtually any real property held for investment can be exchanged for any other like-kind real property held for investment. This definition covers a vast variety of developed and undeveloped real estate. Properties which are clearly not like-kind real property are an investor's primary residence or property held for sale.

The relinquished and replacement properties need not have identical functions (i.e. both be residential rentals or commercial strip centers). The key issue is that the taxpayer should be able to substantiate that both properties were held for investment.

Requirement #2: The IRS requires the taxpayer to identify the replacement property(ies) within 45 days from closing on the sale of a relinquished property. The 45-day identification period begins on the closing date and the replacement property(ies) must be properly identified in a letter signed by the taxpayer. Taxpayers have a number of ways to properly identify properties. They may identify up to three replacement properties without regard to their total fair market value (Three Property Rule). Alternatively, they can identify an unlimited number of replacement properties, if the total fair market value of all properties is not more than twice the value of the property sold (200% Rule). A taxpayer cannot meet either of these rules if they acquire 95% of the aggregate fair market value of all identified replacement properties.

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Requirement #3: Close on the replacement property by the earliest of either: 180 calendar days after closing on the sale of the relinquished property or the due date for filing the tax return for the year in which the relinquished property was sold (unless an automatic tax-filing extension has been obtained). Example: If a taxpayer closes on the relinquished property sale on December 27th, the exchange period will end on April 15th (assuming this is the due date for their tax return). In this case, the taxpayer would have to close on the replacement property (or file the appropriate extension) by April 15th. A taxpayer may choose to close both transactions within a shorter period of time, but the maximum time period is 180 calendar days.

Requirement #4: The most common exchange format, the delayed exchange, requires investors to work with an IRS-approved third-party principal called a qualified intermediary. The qualified intermediary documents the exchange by preparing the necessary paperwork (Exchange Agreement and other documents), holds the exchange proceeds on behalf of the taxpayer, and structures the exchange after an assignment of the sale and purchase contracts by selling the relinquished property and purchasing the replacement property.

Note: To defer all capital gain taxes, a taxpayer must buy like-kind property(ies) of equal or greater value (net of closing costs), reinvesting all net proceeds from the sale of the relinquished property. Any funds not reinvested or any reduction in debt liabilities not made up for with additional cash from the taxpayer is considered boot and is potentially taxable to the extent the taxpayer has a capital gain tax consequence.

When Are Capital Gain Taxes Paid?

The capital gain taxes on a 1031 exchange are deferred into the future and are only recognized when a taxpayer actually sells the property for cash instead of performing a 1031 exchange. A taxpayer will then generally recognize gain if they have some taxable boot in a partially-deferred exchange. Investors can continue to exchange properties as often and for as long as they wish.

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