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Top ten frequently asked 1031 Tax-Deferred Exchange questions

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What is a 1031
tax-deferred exchange?

A 1031 tax-deferred exchange is a method allowed by Internal Revenue Code (IRC) §1031, whereby an owner of certain investment or business property may defer paying capital gains taxes on the sale of such property if the owner acquires "like kind" property within a certain period of time.

What property qualifies
as "like kind" property?

All real estate held for investment or business purposes may be considered "like kind" to any other real estate held for investment or business purposes. For example, raw land can be exchanged for an apartment building. The Exchanger must be able to demonstrate that both the property being sold and the property being bought is held for business or investment purposes.

Besides deferring capital gains taxes, are there other motives for an exchange?

Deferring capital gains taxes is clearly a key reason to exchange. However, by exchanging, the exchanger may also accomplish the following:

- (i) exchange several smaller hard to manage properties for one larger easier to manage property;
- (ii) exchange a partial interest in one property to a full interest in another property;
- (iii) exchange raw land for rental property to generate cash flow;
- (iv) exchange depreciated property to higher value property that can be depreciated; or
- (v) exchange a rental property in Boston for a rental property in Florida, which might later be a principal residence or a vacation home.

What is a Qualified
Intermediary?

A Qualified Intermediary (QI) is a neutral party who facilitates the exchange by drafting the proper documentation and by holding the proceeds from the sale of the relinquished property and then uses such proceeds for the purchase of the replacement property.

What are the mechanics
of an exchange?

Most exchanges are delayed exchanges wherein the exchanger first sells the relinquished property, and the net proceeds go to the QI. Exchanger buys a replacement property and the QI delivers the monies that they are holding to the closing attorney.

What must I do in
order to defer paying
all capital gains taxes?

In order for an investor to defer all capital gains taxes:

- * The replacement property must be equal to or greater in value than the relinquished property.
- * All net proceeds must be used to acquire replacement property.
- * To the extent that the value, debt or equity on the replacement property is less than the value, debt or equity on the relinquished property, the exchanger may have taxable boot.

Are there time limitations to complete an exchange?

An exchanger must identify the replacement property within 45 days after the sale of the relinquished property and close on an identified replacement property within 180 days after the close of the relinquished property.

How many properties
can I identify?

- * 3 Property Rule: You can identify up to three properties regardless of their price.
- * 200% Rule: You can identify more than 3 properties so long as the fair market value of all the properties you identify is not more than twice as much as the relinquished property.

Can I buy a Replacement
Property before I sell my
Relinquished Property?

This is known as a "reverse exchange." In September 2000, the IRS issued Revenue Procedure 2000-37 which is a "safe harbor" for completing 1031 reverse exchanges. Although somewhat more complicated, with careful structuring and planning, reverse exchanges (and construction and improvement exchanges) can be a viable option.

In what tax year is the
exchange reported?

The exchanger must file Form 8824 for each tax year property was transferred to another party in an exchange.

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