

## 1031 exchange



# What is a tax-deferred exchange and how does it benefit the taxpayer?

**ds Diane Schaefer**



**Exchange Solutions**

The purpose of an exchange is to defer the payment of taxes on some or all of the capital gain in a property being sold. Anyone who is thinking about selling a business use, rental or investment property, and has a gain or taxable recapture, may want to consider an IRC Section 1031 exchange. Whether the investor's property is owned free and clear or encumbered, the benefit of a tax-deferred exchange can be significant. Regardless of the current economic market conditions, property owners selling commercial real estate can still possibly take a hit on capital gains although property values have decreased adding insult to injury. So why pay the government, when one can reinvest that money into new, larger or several properties.

Through Section 1031 of the Internal Revenue Code of 1986, as amended, the IRS recognized that an exchange of like-kind property is not a taxable event. Section 1031(a) reads, "Nonrecognition of gain or loss from exchanges solely in kind - (1) In general, no gain or loss shall be recognized on the exchange property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like-kind which is to be held either for productive

use in a trade or business or for investment."

The basic types of exchanges are delayed, simultaneous, construction, build to suit, reverse and personal property. A delayed exchange allows the taxpayer 45 days to identify the replacement property to be purchased. A simultaneous exchange is convenient for the taxpayer that has located a replacement property and is prepared to sell and buy within the same day. Construction and build-to-suit exchanges are available to taxpayers that are in need of improvements on the replacement property, or are acquiring vacant land and desire to use a portion of the exchange funds to build on the vacant land. If a taxpayer has located a replacement property but has not found a purchaser for

their sale property, then a reverse exchange would be an option. A property owner can use any of the above profiles for any type of like-kind property whether it is real or personal. Some examples where personal property exchanges have been utilized are artwork, jewelry, livestock, boats, airplanes, cars and non-tangible assets as well.

Unlike a sale and a purchase of property, key requirements must be adhered to in order for the taxpayer to enjoy a successful exchange. These key elements are as follows: the taxpayer (1) cannot have actual or constructive receipt of the sale proceeds, (2) must utilize an intermediary prior to the close of the sale of the relinquished property, (3) needs to identify the replacement property within 45 days of the

closing of the relinquished property, (4) must apply one of the three identification rules: the three-property rule, the two-hundred percent rule, or the 95% rule, (5) complete the sale/purchase transaction by the earlier of 180 days from the date of the first closing or the due date of the taxpayer's tax return (including extensions) for the year in which the relinquished property was sold, (6) cannot have access to the sale proceeds until (i) after the end of the 45-day identification period, if there were no properties identified, (ii) after the taxpayer has received all identified replacement properties, (iii) after the end of the 180-day exchange period.

The use of a qualified intermediary has become the prevalent method of handling deferred exchanges

and a knowledgeable, experienced qualified intermediary ensures that taxpayers follow all requirements and conditions to have a seamless transaction. One important note, since the qualified intermediary cannot act as an agent of the taxpayer and, therefore, cannot serve as the tax advisor, a taxpayer should always consult with a tax advisor and attorney while engaging in a tax-deferred exchange. In recent years, there has been a substantial growth within the northeast region as more people have become aware of this key asset preserving strategy.

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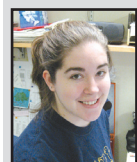
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