I.R.C. § 1031 REFERENCE GUIDE

IPE 1031

QUALIFIED INTERMEDIARY SERVICES

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I.R.C. § 1031 PURPOSE:

Section 1031 allows owners of business and investment property to defer payment of capital gains taxes by reinvesting all proceeds from the sale of a currently owned property (relinquished property) into new like-kind property (replacement property).

TYPES OF EXCHANGES:

Delayed: A delayed exchange occurs when a taxpayer, utilizing the services of a qualified intermediary, first sells relinquished property and subsequently acquires replacement property. Subject to certain rules, the taxpayer has up to 180 days from the transfer of the relinquished property to acquire replacement property.

Reverse: A reverse exchange occurs when a taxpayer, utilizing the services of a qualified intermediary and an exchange accommodation titleholder (EAT), acquires replacement property before disposing of relinquished property. In a reverse exchange, § 1031 requires that the EAT take actual title to the replacement property until the relinquished property is sold. A reverse exchange benefits a taxpayer when the taxpayer must purchase the replacement property before being able to sell relinquished property. To fall within the safe harbor of § 1031, the transaction must be completed within the 180-day time period.

Improvement: Taxpayers who desire to construct improvements on replacement property, utilizing relinquished property proceeds on deposit with a qualified intermediary, can do so by structuring the transaction as an improvement exchange. Improvement exchanges are similar to reverse exchanges in that an EAT must take actual title to the replacement property while it is under construction. To fall within the safe harbor of § 1031, the transaction must be completed within the 180-day time period.

Non-Safe Harbor Build-to-Suit: In many circumstances, improvement exchanges cannot be completed within the 180-day safe-harbor period. For such occasions, a § 1031 exchange can be structured outside of the safe-harbor provisions of § 1031 and still qualify for § 1031 treatment.
In this instance, a third party must take actual title to the property and have a beneficial and significant interest in the transaction.

QUALIFYING PROPERTY:

Real Property: Generally speaking, nearly all types of real estate are classified as like-kind to each other. So long as a piece of real property is used for investment or for use in a business, it will qualify for § 1031 treatment. Examples of real properties that can be exchanged for one another include the following: rental properties, farms and ranches, office buildings, motels and hotels, golf courses, raw land, industrial properties, retail properties, storage units, vacation homes under certain limitations, and properties leased for 30 years or more.

Personal Property: Personal property can be exchanged utilizing § 1031 so long as it is used for investment or used in a trade or business, and is traded for like-kind property. This may become an issue when businesses or apartment complexes are traded and items of personal property (stoves, washers, dryers, refrigerators, etc.) exceed 15% of the underlying real estate's value.

REASONS TO EXCHANGE:

Generally speaking, the principal advantage of a § 1031 exchange is the ability to use the entire equity of a property owned by a taxpayer to acquire replacement property. Tax consequences of selling property are taken out of the equation and taxpayers are free to move equity into more lucrative or appropriate investments. Some specific reasons for using § 1031 are as follows:

Consolidation or Diversification: A taxpayer may wish to decrease the number of properties held by exchanging out of multiple relinquished properties into fewer or single replacement properties. The effect could be reduced managerial and maintenance burdens. Alternatively, a taxpayer may wish to exchange out of one high value property into multiple properties to limit investment exposures, diversify holdings, or increase cash flow.

Relocation of Investment: Taxpayers who relocate from one part of the country to another can utilize § 1031 to move real property investments to the taxpayer's new location and avoid payment of capital gains tax.

Stepped-up Basis for Heirs: Heirs who inherit property from a taxpayer who has utilized § 1031 to defer taxable gain through the life of the investment(s) will acquire the property at a stepped-up basis. The effect being that the heir's basis equals the fair market value (FMV) of the property at the time of the taxpayer's death and no tax will be paid by the heir to the extent the sale price does not exceed FMV at the time of death.

IMPORTANT RULES AND RESTRICTIONS:

45-Day Identification Rule: After a taxpayer sells the original relinquished property, replacement properties must be identified by the 45th day following the transfer.

Three-Property Identification Rule: A taxpayer may identify up to three properties without regard to the relinquished property's FMV.

200% Identification Rule: In the alternative to the Three-Property Rule, a taxpayer may identify any number of properties, so long as the aggregate FMV of all identified properties does not exceed 200% of the FMV of the relinquished property on the date it was sold.

95% Identification Rule: A taxpayer may identify any number of properties, without regard to FMV, so long as 95% of the identified properties are actually acquired.

180-Day Exchange Period Rule: After identification, closing on all replacement properties must occur at the end of the 180th day following the transfer of the relinquished property; or, the due date of the taxpayer's federal tax return for the year in which the property was relinquished, including extensions, whichever is earlier.

TO AVOID ALL TAXABLE GAIN, the general rule is that taxpayers must acquire replacement property that has a FMV equal to or greater than the FMV of the relinquished property, and all equity must be reinvested into the replacement property.

SAMPLE COOPERATION LANGUAGE:

Purchase and sale contracts for § 1031 transactions should contain cooperation language. An example follows. However, the sample language should be modified to fit the specifics of each particular transaction.

> It is the intention of Seller to transfer the subject property pursuant to Internal Revenue Code Section 1031, which sets forth the requirements for tax-deferred real estate exchanges. Seller's rights and obligations under this and future agreements may be assigned to a qualified intermediary for the purpose of completing an exchange. Buyer agrees to cooperate with Seller in a manner necessary to enable Seller to complete an exchange. Such cooperation shall be at no additional cost or liability to Buyer.

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