1031Vest Frequently Asked Questions

What is a tax-deferred exchange?

In a typical transaction, the property owner is taxed on any gain realized from the sale. However, through a Section 1031 Exchange, the tax on the gain is deferred until some future date.

Section 1031 of the Internal Revenue Code provides that no gain or loss shall be recognized on the exchange of property held for productive use in a trade or business, or for investment. A tax-deferred exchange is a method by which a property owner trades one or more relinquished properties for one or more replacement properties of "like-kind", while deferring the payment of federal income taxes and some state taxes on the transaction.

The theory behind Section 1031 is that when a property owner has reinvested the sale proceeds into another property, the economic gain has not been realized in a way that generates funds to pay any tax. In other words, the taxpayer's investment is still the same, only the form has changed (e.g. vacant land exchanged for apartment building). Therefore, it would be unfair to force the taxpayer to pay tax on a "paper" gain.

The like-kind exchange under Section 1031 is tax-deferred, not tax-free. When the replacement property is ultimately sold (not as part of another exchange), the original deferred gain, plus any additional gain realized since the purchase of the replacement property, is subject to tax.

What are the benefits of exchanging v. selling?

- A Section 1031 exchange is one of the few techniques available to postpone or potentially eliminate taxes due on the sale of qualifying properties.
- By deferring the tax, you have more money available to invest in another property. In effect, you receive an interest free loan from the federal government, in the amount you would have paid in taxes.
- Any gain from depreciation recapture is postponed.
- You can acquire and dispose of properties to reallocate your investment portfolio without paying tax on any gain.

What are the different types of exchanges?

- Simultaneous Exchange: The exchange of the relinquished property for the replacement property occurs at the same time.
- Delayed Exchange: This is the most common type of exchange. A Delayed Exchange occurs when there is a time gap between the transfer of the Relinquished Property and the acquisition of the Replacement Property. A Delayed Exchange is subject to strict time limits, which are set forth in the Treasury Regulations.
- Build-to-Suit (Improvement or Construction) Exchange: This technique allows the taxpayer to build on, or make improvements to, the replacement property, using the exchange proceeds.
- Reverse Exchange: A situation where the replacement property is acquired prior to transferring the relinquished property. The IRS has offered a safe harbor for reverse exchanges, as outlined in Rev. Proc. 2000-37, effective September 15, 2000. These transactions are sometimes referred to as "parking arrangements" and may also be structured in ways which are outside the safe harbor.
- Personal Property Exchange: Exchanges are not limited to real property. Personal property can also be exchanged for other personal property of like-kind or like-class.

What are the requirements for a valid exchange?

- Qualifying Property - Certain types of property are specifically excluded from Section 1031 treatment: property held primarily for sale; inventories; stocks, bonds or notes; other securities or evidences of indebtedness; interests in a partnership; certificates of trusts or beneficial interest; and choses in action. In general, if property is not specifically excluded, it can qualify for tax-deferred treatment.
- Proper Purpose - Both the relinquished property and replacement property must be held for productive use in a trade or business or for investment. Property acquired for immediate resale will not qualify. The taxpayer's personal residence will not qualify.

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- Like Kind - Replacement property acquired in an exchange must be "like-kind" to the property being relinquished. All qualifying real property located in the United States is like-kind. Personal property that is relinquished must be either like-kind or like-class to the personal property which is acquired. Property located outside the United States is not like-kind to property located in the United States.
- Exchange Requirement - The relinquished property must be exchanged for other property, rather than sold for cash and using the proceeds to buy the replacement property. Most deferred exchanges are facilitated by Qualified Intermediaries, who assist the taxpayer in meeting the requirements of Section 1031.

What are the general guidelines to follow in order for a taxpayer to defer all the taxable gain?

- The value of the replacement property must be equal to or greater than the value of the relinquished property.
- The equity in the replacement property must be equal to or greater than the equity in the relinquished property.
- The debt on the replacement property must be equal to or greater than the debt on the relinquished property.
- All of the net proceeds from the sale of the relinquished property must be used to acquire the replacement property.

When can I take money out of the exchange account?

Once the money is deposited into an exchange account, funds can only be withdrawn in accordance with the Regulations. The taxpayer cannot receive any money until the exchange is complete. If you want to receive a portion of the proceeds in cash, this must be done before the funds are deposited with the Qualified Intermediary.

What is a Qualified Intermediary (QI)?

A Qualified Intermediary is an independent party who facilitates tax-deferred exchanges pursuant to Section 1031 of the Internal Revenue Code. The QI cannot be the taxpayer or a disqualified person.

- Acting under a written agreement with the taxpayer, the QI acquires the relinquished property and transfers it to the buyer.
- The QI holds the sales proceeds, to prevent the taxpayer from having actual or constructive receipt of the funds.
- Finally, the QI acquires the replacement property and transfers it to the taxpayer to complete the exchange within the appropriate time limits.

Why is a Qualified Intermediary needed?

The exchange ends the moment the taxpayer has actual or constructive receipt (i.e. direct or indirect use or control) of the proceeds from the sale of the relinquished property. The use of a QI is a safe harbor established by the Treasury Regulations. If the taxpayer meets the requirements of this safe harbor, the IRS will not consider the taxpayer to be in receipt of the funds. The sale proceeds go directly to the QI, who holds them until they are needed to acquire the replacement property. The QI then delivers the funds directly to the closing agent.

Can the taxpayer just sell the relinquished property and put the money in a separate bank account, only to be used for the purchase of the replacement property?

The IRS regulations are very clear. The taxpayer may not receive the proceeds or take constructive receipt of the funds in any way, without disqualifying the exchange.

If the taxpayer has already signed a contract to sell the relinquished property, is it too late to start a tax-deferred exchange?

No, as long as the taxpayer has not transferred title, or the benefits and burdens of the relinquished property, she/he can still set up a tax-deferred Exchange. Once the closing occurs, it is too late to take advantage of a Section 1031 tax-deferred exchange (even if the taxpayer has not cashed the proceeds check).

Does the Qualified Intermediary actually take title to the properties?

No, not in most situations. The IRS regulations allow the properties to be deeded directly between the parties, just as in a normal sale transaction. The taxpayer's interests in the property purchase and sale contracts are assigned to the QI. The QI then instructs the property owner to deed the property directly to the appropriate party (for the relinquished property, its buyer; for the replacement property, taxpayer).

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What are the time restrictions on completing a Section 1031 exchange?

A taxpayer has 45 days after the date that the relinquished property is transferred to properly identify potential replacement properties. The exchange must be completed by the date that is 180 days after the transfer of the relinquished property, or the due date of the taxpayer's federal tax return for the year in which the relinquished property was transferred, whichever is earlier. Thus, for a calendar year taxpayer, the exchange period may be cut short for any exchange that begins after October 17th. However, the taxpayer can get the full 180 days, by obtaining an extension of the due date for filing the tax return.

What if the taxpayer cannot identify any replacement property within 45 days, or close on a replacement property before the end of the exchange period?

Unfortunately, there are no extensions available. If the taxpayer does not meet the time limits, the exchange will fail and the taxpayer will have to pay any taxes arising from the sale of the relinquished property.

Is there any limit to the number of properties that can be identified?

Here are three rules that limit the number of properties that can be identified. The taxpayer must meet the requirements of at least one of these rules:

- 3-Property Rule: The taxpayer may identify up to 3 potential replacement properties, without regard to their value; or
- 200% Rule: Any number of properties may be identified, but their total value cannot exceed twice the value of the relinquished property, or
- 95% Rule: The taxpayer may identify as many properties as he wants, but before the end of the exchange period the taxpayer must acquire replacement properties with an aggregate fair market value equal to at least 95% of the aggregate fair market value of all the identified properties.

What are the requirements to properly identify replacement property?

Potential replacement property must be identified in a writing, signed by the taxpayer, and delivered to a party to the exchange who is not considered a "disqualified person". A "disqualified" person is any one who has a relationship with the taxpayer that is so close that the person is presumed to be under the control of the taxpayer. Examples include blood relatives, and any person who is or has been the taxpayer's attorney, accountant, investment banker or real estate agent within the two years prior to the closing of the relinquished property. The identification cannot be made orally.

Are Section 1031 Exchanges limited only to real estate?

No. Any property that is held for productive use in a trade or business, or for investment, may qualify for tax-deferred treatment under Section 1031. In fact, many exchanges are "multi-asset" exchanges, involving both real property and personal property.

What is a "multi-asset" exchange?

A multi-asset exchange involves both real and personal property. For example, the sale of a hotel will typically include the underlying land and buildings, as well as the furnishings and equipment. If the taxpayer wants to exchange the hotel for a similar property, he would exchange the land and buildings as one part of the exchange. The furnishings and equipment would be separated into groups of like-kind or like-class property, with the groups of relinquished property being exchanged for groups of replacement property.

Although the definition of like-kind is much narrower for personal property and business equipment, careful planning will allow the taxpayer to enjoy the benefits of an exchange for the entire relinquished property, not just for the real estate portion.

What is a reverse exchange?

A reverse exchange, sometimes called a "parking arrangement," occurs when a taxpayer acquires a Replacement Property before disposing of their Relinquished Property. A "pure" reverse exchange, where the taxpayer owns both the Relinquished and Replacement properties at the same time, is not allowed. The actual acquisition of the "parked" property is done by an Exchange Accommodation Titleholder (EAT) or parking entity.

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Is a reverse exchange permissible?

Yes. Although the Treasury Regulations still do not apply to reverse exchanges, the IRS issued "safe harbor" guidelines for reverse exchanges on September 15th, 2000, in Revenue Procedure 2000-37. Compliance with the safe harbor creates certain presumptions that will enable the transaction to qualify for Section 1031 tax-deferred exchange treatment.

How does a reverse exchange work?

In a typical reverse (or "parking") exchange, the "Exchange Accommodation Titleholder" (EAT) takes title to ("parks") the replacement property and holds it until the taxpayer is able to sell the relinquished property. The taxpayer then exchanges with the EAT, who now owns the replacement property. An exchange structured within the safe harbor of Rev. Proc. 2000-37 cannot have a parking period that goes beyond 180 days.

What happens if the exchange cannot be completed within 180 days?

If the reverse exchange period exceeds 180 days, then the exchange is outside the safe harbor of Rev. Proc. 2000-37. With careful planning, it is possible to structure a reverse exchange that will go beyond 180 days, but the taxpayer will lose the presumptions that accompany compliance with the safe harbor.

Can the proceeds from the relinquished property be used to make improvements to the replacement property?

Yes. This is known as a Build-to-Suit or Construction or Improvement Exchange. It is similar in concept to a reverse exchange. The taxpayer is not permitted to build on property she already owns. Therefore, an unrelated party or parking entity must take title to the replacement property, make the improvements, and convey title to the taxpayer before the end of the exchange period.

What is the difference between "realized" gain and "recognized" gain?

Realized gain is the increase in the taxpayer's economic position as a result of the exchange. In a sale, tax is paid on the realized gain. Recognized gain is the taxable gain. Recognized gain is the lesser of realized gain or the net boot received.

What is Boot?

Boot is any property received by the taxpayer in the exchange which is not like-kind to the relinquished property. Boot is characterized as either "cash" boot or "mortgage" boot. Realized Gain is recognized to the extent of net boot received.

What is Mortgage Boot?

Mortgage Boot consists of liabilities assumed or given up by the taxpayer. The taxpayer pays mortgage boot when he assumes or places debt on the replacement property. The taxpayer receives mortgage boot when he is relieved of debt on the replacement property. If the taxpayer does not acquire debt that is equal to or greater than the debt that was paid off, they are considered to be relieved of debt. The debt relief portion is taxable, unless offset when netted against other boot in the transaction.

What is Cash Boot?

Cash Boot is any boot received by the taxpayer, other than mortgage boot. Cash boot may be in the form of money or other property.

What are the boot "netting" rules?

- Cash boot paid offsets cash boot received.
- Cash boot paid offsets mortgage boot received (debt relief).
- Mortgage boot paid (debt assumed) offsets mortgage boot received.
- Mortgage boot paid does not offset cash boot received.

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