

Basics of a 1031 Exchange

Many owners of investment and business properties are not aware of the opportunity to save thousands of dollars in capital gains taxes by exchanging, rather than selling, these capital assets.

A Like Kind Exchange under Section 1031 of the Internal Revenue Code provides that the federal capital gains taxes are deferred when business or investment real estate or personal property is exchanged rather than sold.

Basics about exchanges include:

- Most sellers of business or investment property will pay federal capital gains taxes of 20% of the appreciation, plus 25% of any depreciation taken on the property, less sales costs.
- Most states also impose their own income tax on the sale of business or investment property, but many recognize the deferral of such taxes for a Like Kind Exchange under Section 1031.
- Payment of the federal capital gain taxes, and most states' income taxes, is deferred until the property received in an exchange is sold or otherwise conveyed in a taxable transfer.
- A sale of business or investment property followed by reinvestment in other property does not qualify as a Like Kind Exchange. An investor must set up an exchange before title to the property being sold is transferred.
- A qualified independent third party must be used to facilitate the exchange to satisfy the requirements imposed by the I.R.S. for a valid 1031 exchange. Using a Qualified Intermediary under Section 1031 ensures an exchange will receive favorable tax treatment. The Qualified Intermediary participates on the investor's behalf by acquiring and conveying exchange properties and holding the sales proceeds.

- Property to be exchanged must be investment property such as raw land held for appreciation or second "vacation" homes, or trade or business property such as rental real estate, farm and ranch real estate, and aircraft, equipment and other personal property used in the taxpayer's business.
- All properties given and received in a Like Kind Exchange must be "like kind" to one another. Fortunately, all interests in real estate are like kind to each other, making it possible to exchange improved property for unimproved property, urban property for rural property, a condominium for a duplex, a rental house for a motel, vacant land for an office building, etc. Most corporate aircraft, both fixed wing and helicopters, are also like kind to one another.
- An investor exchanging property has 45 calendar days after the closing to identify up to three properties he or she is interested in acquiring, and 180 calendar days after the closing to acquire any or all of the identified property or properties as part of the exchange.
- To defer all of the capital gains, an investor must acquire property of equal or greater in value to the property sold, and must reinvest all equity from the property sold. Receiving cash, or trading down in value, is treated as boot and taxed as capital gain.

***THE INFORMATION ABOVE IS NOT TO BE CONSTRUED AS TAX OR LEGAL ADVICE.
IF TAX OR LEGAL ADVICE IS NEEDED, AN ATTORNEY, ACCOUNTANT,
OR OTHER QUALIFIED COUNSEL SHOULD BE CONSULTED.***

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