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Commercial classroom: 1031 Exchanges: Part 1 - by Edward Smith

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We will begin this article by looking at the history of 1031 Exchanges, next month we will illustrate the procedure and rules.

Congress, in an effort to pay for the American Civil War, imposed the first income tax in 1861. The Revenue Act of 1861 collected a tax of 3% of all incomes over $800 a year. As time went on, issues of tax policies, rates and “fairness” plus how to stimulate the economy were continually discussed in Congress.

When someone sold a property how could they be incentivized to buy another property rather than hoard the money (that was left after paying taxes on the sale)? After all, if the money from the sale were reinvested into a replacement property there was no economic gain or cash to pay the taxes. Thus in the Revenue Act of 1921 the first tax deferred like kind exchange was authorized. In 1928 this was formally titled Section 112(b)(1) of the tax code.

In 1935 the concept of using a Qualified Intermediary (Accommodator) to conduct the exchange was added. The Federal Tax Code was amended in 1954 to change the section number from 112(b)(1) to Section 1031.

Prior to 1979 exchanges were accomplished in a one day long closing; the relinquished property being sold followed by the replacement property being purchased.

T.J. Starker and his son sold timberland to Crown Zellerback, Inc. in exchange for a contract to acquire certain properties within 5 years. The IRS disallowed this “delayed” exchange. In 1979 the Starker Family sued the IRS and won the case setting precedent for today’s non-simultaneous, delayed tax deferred exchanges. In 1984 Congress adopted the 45 calendar day identification Period and the 180 calendar day Exchange Period; imposing a limit on the length of the exchange opportunity.

The Tax Reform Act of 1986 restricted tax benefits of owning real estate and really catapulted 1031 exchanges into the forefront. The act eliminated preferred capital gains treatment, taxing them as ordinary income; eliminated accelerated depreciation in favor of straight line over 27.5 years for residential property and 39 years for commercial property.

In 1990 the IRS issued comprehensive Tax-Deferred Exchange Regulations which for the most part are today's guidelines.

Two additional advances have occurred since, in 2002 fractional or co-ownership of real estate known as Tenant-In-Common ownership was authorized to be used in an exchange. In 2004 Delaware Statutory Trusts were ruled as being real estate and therefore as a replacement property solution for 1031 exchanges.

The first benefit of 1031 Exchanges is to defer the Capital Gains Taxes when selling investment property to the property being purchased.

Many investors do 1031 Exchanges every few years, each time buying a more expensive property, with the money saved by not having to pay the capital gains taxes at that time, thus increasing their cash flow and wealth.

The greatest benefit is to their Heirs. When the taxpayer dies the property goes to their heirs on a "Stepped-Up Basis". All the built-up capital gain disappears. The current market value of the property at that time passes to your estate, if the property is then sold there would be no appreciation or depreciation and no capital gains taxes due.

1031 Tax Deferred Exchanges have a long history of benefits to real estate investors and to our economy, these statutes must be preserved.

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