



## **Commercial Classroom: 1031 tax deferred exchanges part 2 - by Edward Smith**

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The sale of real estate held for more than 12 months triggers Capital Gains taxes on the Net Profits of that sale. These taxes may be deferred by participating in a 1031 Tax Exchange, in essence, by purchasing property(s) to replace the one(s) being sold. However, there are stringent rules and timetables that must be complied with. This applies to the sale of commercial or investment property, but not your personal residence.

The entity that conducts the 1031 Exchange is known as a Qualified Intermediary (QI). The IRS requires that a "third party" conducts the exchange, so the QI will act as a principal in the transaction. How it basically works: the taxpayer will relinquish property title (of the property being sold) to the Intermediary, who will actually sell the property and hold the sale proceeds. Then the QI will act as the buyer of the replacement property being purchased. The QI prepares all the required documentation, provides complete accounting to the taxpayer, and concludes by transferring the title of the new acquired property to the taxpayer.

There are many types of exchanges, in this article we will only discuss the fundamentals. If your client is interested in a 1031 Exchange they should consult a Qualified Intermediary before listing their property for sell.

A few important rules about these transactions:

1031 Exchanges can only be don't in the contiguous 48 States, they may sell property in one State and buy property in another

Qualified Intermediaries (QI): Currently there are no licensing requirements. Clients should request how their monies will be safeguarded, is the QI insured, bonded etc.?

The QI cannot be the taxpayer. Or the taxpayer's accountant, attorney, or real estate agent, who worked with the taxpayer during the prior two years, they are disqualified from serving as the QI.

## Qualified Properties

Replacement property acquired in an Exchange must be like kind to the property being relinquished (sold).

Like kind means “similar in nature or character, notwithstanding differences in grade or quality.” Both the relinquished and the replacement properties must be held by the Exchanger for investment purposes or for “productive use in their trade or business”.

Over the years this definition has gotten broader now you can mix and match any investment property, for example: selling an office building and buying a retail center, selling a retail center and buying a multi-family or selling industrial property and buying an office building.

Personal Property is not eligible for exchange.

## General Rules

The transaction begins on the date the title to the relinquished property (being sold) is transferred to the Qualified Intermediary.

The taxpayer must identify the replacement property(s) (being acquired) within a 45 day acquisition period, following the transfer of the relinquished property.

Title to the replacement property must be received within 180

Calendar days after the transfer of the relinquished property.

All proceeds of the sale of the relinquished property must be held by a third party, a “Qualified Intermediary”.

All cash proceeds must be invested to have a fully deferred taxable gain.

## Three Acquisition Rules

The Three-Investment Property Rule states that the exchanger must identify up to, but no more than three potential investment properties during the acquisition period.

The Two Hundred Percent Rule - This rule dictates that, in the event that three or more like kind investment properties are selected as replacement investment properties, the aggregate market value of said investment properties being purchased may not exceed 200% of the market value of relinquished investment property.

The Ninety-five Percent Exception. In the event that rules 1 and 2 do not apply, the Ninety-Five Percent Exception takes precedence. This rule dictates that the aggregate market value of all replacement investment properties must represent at least 95% of the value of the relinquished investment properties in order for the exchange to still qualify.

## Full and Partial Exchanges

When all the proceeds of the sale are used to purchase a replacement property and the value, equity and debt are all “equal to or greater than” a full deferral of the Capital Gains Tax is possible. If all these rules are not complied with, a partial deferral of the taxes may be possible.

“Boot” – A term used to describe other non-qualified property received in an exchange, that is not like kind to the property acquired. (cash, stock, personal property)

The “boot” proceeds in the exchange are considered a gain and are taxable.

For a full deferral of capital gains taxes, the value, equity and debt must be “equal to or greater than”.

### Examples:

Full Deferral of Capital Gains Tax – each category is “equal to or greater than”.

	Relinquished Sold Property	Replacement Purchased Property
Value	\$450,000	\$600,000
Equity	\$200,000	\$200,000
Debt	\$250,000	\$400,000

### Partial Deferral of Capital Gains Tax

In this case the taxpayer is taking \$50,000 cash from the equity they have in the building they are selling. The “equity” is not equal to or greater then, consequently this “Cash Boot” will be subject to the Capital Gains Taxes.

	Relinquished Sold Property	Replacement Purchased Property
Value	\$450,000	\$600,000
Equity	\$200,000	\$150,000
Debt	\$250,000	\$450,000

### Partial Deferral of Capital Gains Tax

In this case the taxpayer is buying a property for less money than the property they are selling, their “value and debt” will no longer be equal to or greater than. The IRS considers mortgage reduction a taxable event. Consequently, the taxpayers “Mortgage Boot” of \$100,000 will be subject to Capital Gains Taxes.

	Relinquished Sold Property	Replacement Purchased Property
Value	\$450,000	\$350,000
Equity	\$200,000	\$200,000
Debt	\$250,000	\$150,000

As one can see 1031 Tax Deferred Exchanges can be very beneficial but they are complicated with many rules (only some of which we have examined in this article). There are many different types of exchanges and clients need to speak with a specialist, a Qualified Intermediary.

The most important aspect of 1031 Exchanges is the timeline. All parts of the transaction must be completed in 180 calendar days. Problems can occur, what if the selected property to purchase is found to have pollution problems during the due diligence period or the income and expenses represented by the seller are not true. One could run out of time!

There is a possibility of doing a 1031 Exchange by acquiring a share of a property through Tenants-in-Common or Delaware Statutory Trust structures, which can usually be closed in a matter of weeks.

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 their estate, if the property is then sold there would be no appreciation or depreciation and no capital gains taxes due.

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