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Use a Â§1031 exchange to postpone paying gains tax

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When you, the taxpayer, (whether as an individual or as an entity) own property held for investment or for business use, sell it at a gain, you incur a gains tax at the time of the sale. Internal Revenue Code's section 1031 allows you to postpone the payment of such tax if the proceeds are utilized towards the purchase of a replacement property in a qualifying like-kind exchange. When you defer the tax, it frees up your money to make it available to invest in other projects. Despite its tax savings benefits though, the exchange process can create issues for commercial real estate investors and you ought to be savvy about the definitions of like-kind, timelines, IRS regulations, possible interference with your business models and the complexity of related party issues.

Owners of investment and business property including individuals, C Corporations, S Corporations, partnerships (general or limited), limited liability companies, trusts and other taxpaying entities may engage in a 1031 like-kind exchange. A like-kind property is property of the same nature, character or class. Quality or grade are not of relevance. The relinquished property and the replacement property must be held for use in a trade or business or for investment and be similar enough to qualify as "like-kind." A residential rental house is like-kind to vacant land, but improvements that are conveyed without land are not of like-kind to land. Real property and personal property can both qualify as exchange properties, but real property is not like-kind to personal property. Real property within U.S. is not like-kind to property located outside the U.S.

You have 45 days from the date that the relinquished property is transferred to identify replacement properties. The exchange must be completed within 180 days after the transfer of the relinquished property or by the due date of the taxpayer's federal tax return for the year in which the relinquished property was transferred, whichever is earlier. The replacement property, if disposed of immediately after the exchange, would not be viewed as being "held" for a qualified purpose (investment) under the Internal Revenue Code's section 1031 and may trigger the entire exchange to be treated as a taxable event.

Last but not the least, your business model may dictate that the replacement property be transferred immediately to a corporation, partnership or an LLC, but tread that path with caution, as it may require you to prove your intent to hold the property for investment and IRS may determine that on a case by case basis.

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