Fundamentals and Best Practices of the 1031 Exchange

A 1031 exchange is an IRS rule that allows investors to postpone the recognition of a gain (and the subsequent requirement to pay tax) realized from the disposition of real property when a replacement property of the same type (a qualifying like-kind) is purchased within a specified period of time.[1]

Fundamental to a 1031 exchange is that both the disposed property and the replacement property have to be real property held for either productive use in a trade or business or for investment.[2] Myriad rules and time-sensitive parameters apply, where failure to conform can easily trap the unprepared investor and result in a partial or complete loss of the intended tax benefits.

After closing on the sale of qualifying real property, an investor who wishes to undertake a 1031 exchange has 45 days from the date the property is sold to identify another like-kind replacement property.[3] The identification process should, at a minimum, include a legal document signed and dated by the investor that indicates the name, description and street address of the replacement property.[4] To optimize tax deferral, the investor should identify replacement properties equal to or exceeding the market value of the relinquished property.[5] Up to three replacement properties can be identified, with no value limitation. However, if more than three properties are identified, their combined value cannot exceed 200% of the sale price of the relinquished property.[6] The investor then needs to close on the purchase of the previously identified replacement property(ies) by the earlier of either 180 calendar days from when the relinquished property is sold or by the due date (with extensions) of the income tax return that reports the sale of the relinquished property.[7]

In the simplest of examples, two investors exchange properties of exactly equal value to complete a 1031 exchange. This is deemed a direct trade and rarely seen in practice. In the absence of a direct trade, an investor is required to engage the services of a Qualified Intermediary ("QI") in advance to ensure the deal is structured as an exchange. The QI insulates the investor from any actual or deemed control of exchange funds and professionally facilitates the transaction. It also interfaces with closing attorneys and title companies and collects and disburses all funds relating to the 1031 exchange in a manner consistent with the IRS rules.[8]

To maximize gain deferral, it is imperative to ensure that the relinquished property is exchanged into a property of equal or greater market value. It is also crucial that no cash or other property (referred to as "boot") is received from exchange proceeds, as receipt of boot is recognized as gain.[9]

The avoidance of gain from the receipt of boot may seem straightforward, but in practice the rules and calculations can prove to be nuanced and complex. It is important to engage a tax professional who is experienced in 1031 exchanges to ensure the transaction is a success and that all expectations are achieved.

Examples of Errors Made by Investors

Even investors with the best intentions can make costly mistakes when completing a 1031 exchange without proper guidance. For example:

1. **Investor A** owed significant back taxes on its relinquished property and directed that some of the sale proceeds be used to pay off the liabilities at closing. This resulted in less money going into the QI. The amount of the back taxes was treated as taxable boot that could not be remedied post-closing.

2. **Investor B** sold a property ("relinquished property") worth $1,000,000, subject to debt of $400,000. The investor placed the net proceeds of $600,000 into a QI at closing. Investor B then purchased a replacement property worth $600,000 which was not subject to debt. None of the gain from the relinquished property could be deferred because the replacement property was not the same or greater market value as the relinquished property.

3. **Investor C** did not use a QI for their exchange. Because of this, the IRS deemed that Investor C had retained control of the exchange funds. The IRS did not respect the 1031 transaction and none of the gain could be deferred.

Best Practices

— Always engage a QI to facilitate your exchange.

— Identify replacement property of equal or greater value within 45 days of the sale of the relinquished property.

— Close on the purchase of replacement property of equal or greater value within 180 calendar days of the sale of the relinquished property.

— Avoid being in actual or deemed receipt of cash or other property from sale proceeds of the relinquished property or any other 1031 exchange monies.

— Seek guidance from an experienced tax professional for optimal gain deferral.

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Endnotes

[1] Internal Revenue Code of 1986 (the “Code”) §1031(a)(1).

[2] Id.

[3] Code §1031(a)(3)(A).

[4] Treas. Reg. §1.1031(k)-1(c)(3).

[5] Code §1031(a)(1).

[6] Treas. Reg. §1.1031(k)-1(c)(4)(i); the 200% rule.

[7] Code §1031(a)(3)(B).

[8] Treas. Reg. §1.1031(k)-1(g)(4).

[9] Code §1031(a)(1).