

## 1031 Tax-Deferred Exchanges

A brief summary of advantages and considerations

### What is a Tax Deferred Exchange?

A Tax Deferred Exchange is one of the few tax shelters remaining. Its use permits a taxpayer to relinquish certain investment property and replace it with other "like-kind" investment property without triggering capital gains liability. Thus the owner has additional capital available for the purchase of the "replacement" property, which otherwise would have been paid in taxes. Payment of the tax on the gain is deferred until the final "replacement" property is sold.

### What is a Delayed Exchange?

The Treasury Regulation of 1991 acknowledged the ability to do a "delayed" exchange, as opposed to one done simultaneously.

A number of requirements are imposed including specific time periods for completion of the exchange. The taxpayer must identify the replacement property within 45 days and close the purchase of the replacement property within 180 days (or the date of filing tax return if earlier) of the closing of the relinquished property. Also, the taxpayer cannot receive any proceeds from the sale of the relinquished property, actually or constructively.

Thus, if the replacement property is to be purchased subsequent to the sale of the relinquished property, all money must be held by a "Qualified Intermediary."

### What is the advantage of a 1031 Exchange?

The primary advantage to performing a 1031 Exchange is that through the deferment of capital gains taxes the "Exchangor" is able to acquire more valuable and more leveraged investment property. If it is the intent of the taxpayer to reinvest the proceeds from one property into another, the 1031 Exchange remains the only vehicle remaining for full tax deferment.

The disadvantage is, of course, that funds must remain invested. There is also the additional cost of the transaction, which is the exchange fee.

### Who may act as a Qualified Intermediary?

The Regulations list those parties who may not be qualified to act as an intermediary. If the person is the agent of the Exchangor at the time of the transaction, he is disqualified. This includes any person who has acted as the Exchangor's employee, attorney, accountant, investment banker or broker, or real estate agent or broker within the two year period prior to the date of transfer of the relinquished property, as well as relatives and controlled corporations. Consequently, the role of the Qualified Intermediary has generally been filled by title insurance, escrow, or trust companies.

### Issues to consider when choosing a Qualified Intermediary...

- Are they already disqualified?
- What are the chances of bankruptcy?
- In case of misappropriation of funds, do they have a surety bond?
- In case of death or injury, is there a backup?
- How in depth is their exchange agreement?
- How are the funds deposited?
- How quickly can the funds be released?
- What is the fee structure? Beware of hidden fees.
- Do they pay interest on the proceeds being held?
- Are they a member of the FEA (Federation of Exchange Accommodators)? For more information, visit [www.1031.org](http://www.1031.org).
- Do they have a CES designation? Visit [www.1031ces.org](http://www.1031ces.org) for details.

### What are the qualifications of "like-kind" property?

It is important when identifying a replacement property to choose "like-kind" property. "Likekind" refers to the intended purpose of the property rather than the exact description of the property. Certainly all 1031 Exchanges are real property held for investment purposes, trade, or business, so the exchange of a rental house for a retail center, for example, is acceptable.

The tax code specifically lists properties that are not considered "like-kind." These include 1) stock in trade or other property held primarily for sale; 2) stock, bonds, or notes; 3) other securities or evidences of indebtedness; 4) interests in a partnership; 5) certificates of trust or beneficial interest. Also the property must be in the United States.

## **Ten considerations when completing a 1031 Exchange...**

1. The Taxpayer/Exchangor is advised to consult with his or her CPA or Tax Attorney.
2. The Exchange Addendum should be added to the Contract to Buy or Sell Real Estate.
3. Qualified Intermediary (Q.I.) should be notified.
4. When the title work is ordered, add the Q.I. to delivery.
5. Establish the Exchange Agreement with the Q.I.
6. Inform the Q.I. of the closer or contact with the title company.
7. Attend the closing and make sure that the proceeds go directly to the Q.I.
8. Send your list of Identified Replacement Property(ies) to the Q.I. by the 45 day deadline.
9. Send the Assignment of Contract Replacement Property to the Q.I. prior to closing the Replacement Property.
10. Make sure that the Q.I. has transferred the proceeds to the closer of the Replacement Property and that there is no cash back to the buyer.

## **Have questions?**

If you have any questions on the information contained in this bulletin please call Michael S. Dunn, at 970-309-9249.

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