1031 Property Exchange and it's benefits

by Shahid Habib

A 1031 Exchange is a great way to defer tax on profits gained from the sale of a real estate investment, income or business property. Your leverage increases as a direct result of tax deferment. Thanks to the tax savings, the full sale amount can be applied towards the property being acquired. Thus you can buy a property that is worth more than you could otherwise afford.

This process can be repeated again and again to progressively build your wealth into a large estate by deferring federal taxes and applicable state taxes that would otherwise have to be paid on the capital gain.

IRS Tax Code Section 1031 Exchange is also sometimes referred to as "delayed" or "Starker" exchange named after Mr. Starker, a taxpayer, who in 1979 won an important federal court ruling against the IRS allowing delayed exchanges. Since the ruling, properties no longer have to be simultaneously exchanged on the same day. The titles on the relinquished property and the replacement property do not have to close at the same time. That is why this type of exchange is also called a "deferred exchange".

Another type of Starker exchange called the "reverse exchange" can be used to buy the replacement property even before the relinquished property is sold.

The exchange process involves four main participants:
1. The taxpayer who is referred to as the "exchanger".
2. The buyer of the relinquished property (the property being sold).
3. The seller of the replacement property (the property being purchased).
4. The accommodator also called the "qualified intermediary" or middleman who holds the funds until escrow and then transfers the equity to the title company for a fee.

Real Estate Investors can defer capital gains taxes on the sale of an investment property if they use a "qualified intermediary" or facilitator to hold onto the sale proceeds and invest it in a like kind property.

During the closing process, the intermediary acts both as buyer of the replacement property and seller of the relinquished property. This process of using a middleman to hold the funds saves you from paying capital gains tax as long as you keep doing 1031 Exchanges.

According to IRS regulations the qualified intermediary must be an unrelated party that charges a fee to do the exchange. The intermediary can not be the exchanger's employee, relative, accountant, banker, title company, real estate agent, broker, attorney, trustee or anyone else who acts in a capacity which may be taken as being related to the taxpayer.

A 1031 Exchange can not be done on one's primary residence. Both the relinquished property as well as the replacement property must be investment properties. The replacement property must be identified within 45 days of the close of sale on the relinquished property.

The replacement property must be closed on within 180 days of the close of sale on the relinquished property, or by the due date of your tax return for the year, whichever comes first. If the due date comes first, then filing for a 90 day extension would give more time to close.

The replacement property must be equal to or greater in value than the relinquished property. Up to three replacement properties may be bought regardless of value or a group of properties may be purchased which have a combined value that does not exceed 200% of the value of the sale of the initial relinquished property. This is also known as the "200% rule".

There are many benefits of doing a 1031 Exchange. More desirable properties can be purchased in exchange for selling the less desirable properties that you may own. You can exchange, for example, raw land for a duplex. You can exchange a small rental property and trade up to a multi-unit apartment building thus potentially increasing your equity as a result of buying below market value, getting a greater cash flow and getting a larger depreciable property at the same time.

Please consult a CPA or tax attorney before proceeding on doing a 1031 Exchange to make sure you are following all of the IRS and State Tax Board rules.

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