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Using the 1031 Exchange

Whether you are investing in the stock market, real property, or buying gold, there is a continual challenge of when and how to invest because of the fluctuations of current world events and economics. Buying and selling real-estate can usually weather many changes. Although short-term turnovers in real-estate can be profitable, investors normally realize large gains over longer periods and the general purpose for holding property is to have tax benefits while gaining appreciation.

There are times when real property tax benefits decrease over a period of years or the equity is large enough to reinvest in another property or even multiple ones. Then, the 1031-exchange becomes an invaluable tool for the investor who wants to trade or increase their portfolio.

The basic reason for using this particular tool is that it can be a good way to “postpone” capital gains taxes on your real estate investments. However, there are definite rules for using a 1031 exchange during the buying and selling of real property and you must follow them to qualify for this type of transaction. Here are some of the basic guidelines.

- You can only use a 1031 exchange for investment properties or properties owned for use in business. You cannot use them for your residence or second home unless you are using the property only for rental to third parties.
- All exchanges must be located in the United States.
- You must exchange between like-kind properties. Both properties must be for investment or business purposes, but they do not have to have an exact use. For example, you can exchange an apartment building for a commercial shopping center.
- To meet Internal Revenue Service (IRS) guidelines for an exchange, you must identify the replacement property for the one you are exchanging within 45 days of the initial property transfer date. You can identify up to three properties of like value or as many properties as necessary to total the fair market value of the property you are exchanging. There is more to the IRS specifications than can be

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detailed in this article, so be sure to consult an expert in exchange.

- You must close escrow on the replacement property within 180 days from the initial transfer date of your property to the other party. However, IRS regulations now let you buy the replacement property first - this is termed a “reverse exchange.”
- If the exchange is not simultaneous, you must use a qualified intermediary, such as a bank, attorney, etc. Beware - the Internal Revenue Code describes who cannot be a qualified intermediary – so be careful who you select, and again, consult a professional on exchange.
- If you end up with cash to balance out the value of the two properties, the cash is taxable at current capital-gains rates; this is often termed as “boot.”
- If the property you receive in exchange is from a relative and you then sell the property within two years, the original exchange will not qualify for deferred capital gains.

Exchanges are complicated and this article only outlines some of the major points of a 1031 exchange. Use professionals who know the requirements, as well as the pitfalls, for this type of transaction. The exchange is a great tool, but, if not followed correctly, the IRS could deny the exchange, causing serious tax consequences. In addition, before considering a 1031 Exchange, consult your tax advisor to see *if this will benefit your investments and taxes*.

The 1031 exchange may be the tool for you. Call us if you have questions on the 1031 exchange and we will be happy to assist you.

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