

Preserving Equity — The 1031 Exchange and First American Exchange Company

It is now more commonly known that capital gains taxes can be deferred with an exchange of property meeting the requirements of Section 1031 in the Internal Revenue Code. An exchange differs from a sale in that an exchange requires a transfer of property for “like-kind” property. A sale of property is a transfer of property for money. The primary advantages with an exchange are to defer the capital gains tax and to fully use your equity for acquisition of other property. Even with the reduction of the capital gains tax rates, the benefits of Section 1031 can be very substantial. However, the rules of Section 1031 can trap the unwary and can result in a loss of some or all of the tax deferral benefits. The use of a tax advisor familiar with the rules in Section 1031 and a qualified intermediary like First American Exchange is recommended.

Basic Deferred Exchange Rules

Section 1031 applies to real and personal property that has been held as an investment or held for productive use in a trade or business. The property transferred in the exchange, also called the “relinquished property,” must be “like-kind” to the property acquired, also called the “replacement property.” Under the 1031 rules, like-kind does not mean exactly the same, especially in an exchange of real property. For example, a single-family rental unit may be used to acquire another rental unit, a warehouse, retail center or office building. Substantially, real property is considered like-kind to other real property. The like-kind limitations applied to personal property are much more restrictive. Essentially, items of personal property must be classified similarly under certain government accounting classifications. Real property may not be exchanged for personal property.

There are two time limits critical in a tax deferred exchange. Generally, potential replacement property must be identified within 45 days from transfer date of the relinquished property and acquired within 180 days from the same transfer date, unless the transfer occurs later in the year when the 180-day period can be shortened by the due date of your tax return. If you transfer multiple relinquished properties that close on different dates through one exchange, the identification and exchange periods begin on the date of transfer for the first relinquished property.

Regardless of the number of relinquished properties transferred as part of the same exchange, you can identify three properties without regard to fair market values or any number of properties provided that the fair market values of all identified properties don't exceed 200 percent of the relinquished property values. In other words, if you identify more than three properties, make sure that the values of those properties don't exceed two times the value of the relinquished properties or the IRS will assume that you did not properly identify and will not permit deferral of the capital gains taxes.

There is an exception to the 200 percent rule for any replacement property that you acquire within the identification period or if you acquire 95 percent of the values of the replacement properties. As an example, if you assume a transfer of relinquished property for \$100,000 and identify four properties worth \$55,000 each, you will be treated as if you did not identify any properties unless you close on all four properties. Acquiring three of the four will not be sufficient because it amounts to 75 percent and not 95 percent of the aggregate fair market values of the replacement properties.

As a rule of thumb for tax deferral, you must trade across or up in value and across or up in equity from the relinquished property to the replacement property. There are other rules that can apply when considering any debt relief that occurs in the payoff of loans on the relinquished property. A tax advisor familiar with the exchange rules should be consulted for an appropriate tax analysis.

Selecting Your Qualified Intermediary

As a leader in the exchange industry, First American Exchange of Skagit County and its extended family of facilitators have successfully assisted thousands of investors with their 1031 exchange transactions. We have the reputation and experience to successfully and safely complete your exchange transaction.