AN INTRODUCTION TO THE BENEFITS OF §1031 TAX DEFERRED EXCHANGES

Compliments of

A National IRC §1031 "Qualified Intermediary"

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EXCHANGES ARE A POWERFUL TAX STRATEGY

Tax deferred exchanges have been a part of the tax code since 1921 and are one of the last significant tax advantages remaining for real estate investors. One of the key advantages of a §1031 exchange is the ability to dispose of a property without incurring a capital gain tax liability, thereby allowing the earning power of the deferred taxes to work for the benefit of the investor (called an "Exchanger") instead of the government. In essence, it can be considered an interest-free loan from the IRS.

BASIC TAX EXCHANGE REQUIREMENTS

The IRS allows up to a maximum of 180 calendar days between the sale of the relinquished property and the purchase of the replacement property. Within the 180 day "exchange period," the investor must also properly identify suitable replacement properties within 45 calendar days of closing on the sale of the relinquished property. There are a number of requirements which need to be met to qualify for tax deferral under the tax code:

Requirement #1: Both the "relinquished" and "replacement" properties must be held for investment or used in a business. The IRS uses the term "like-kind" to describe the type of properties that qualify. Any property held for investment can be exchanged for any other "like-kind" property held for investment. This definition covers a vast variety of developed and undeveloped real estate. Properties which are clearly not like-kind are an investor's primary residence or property "held for sale."

The relinquished and replacement properties need not have identical functions (i.e. both be residential rentals or commercial strip centers). The key issue is that the Exchanger can substantiate that both properties were "held for investment."

Requirement #2: The IRS requires an investor to identify the replacement property(s) within 45 days from closing on the sale of a relinquished property. The 45 day Identification Period begins on the closing date, and the replacement property(s) must be properly identified in a letter signed by the Exchanger. Exchangers have a number of ways to properly identify properties. They may identify up to three replacement properties without regard to their total fair market value (Three Property Rule). Alternatively, they can identify an unlimited number of replacement properties, if the total fair market value of all properties is not more than twice the value of the property sold (200% Rule). An Exchanger can not meet either of these rules if they acquire 95%of the aggregate fair market value of all identified replacement properties.

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Requirement #3: Close on the replacement property by the earliest of either: 180 calendar days after closing on the sale of the relinquished property or the due date for filing the tax return for the year in which the relinquished property was sold (unless an automatic filing-extension has been obtained). Example: If an Exchanger closes on the relinquished property on December 27, the exchange period will end on April 15 (assuming this is the due date for their tax return). In this case, they would have to close on the replacement property (or file the appropriate extension) by April 15. Exchangers may choose to close both transactions within a shorter period of time, thereby avoiding the potential hardship of the 45/180 day time limits.

Requirement #4: The most common exchange format, the delayed exchange, requires investors to work with an IRS-approved middleman called a "Qualified Intermediary." The Qualified Intermediary documents the exchange by preparing the necessary paperwork (Exchange Agreement and other documents), holding proceeds on behalf of the Exchanger, and structuring the sale of the relinquished property and purchase of the replacement property.

Note: To defer all capital gain taxes, an Exchanger must buy a property or properties of equal or greater value (net of closing costs), reinvesting all net proceeds from the sale of the relinquished property. Any funds not reinvested, or any reduction in debt liabilities not made up for with additional cash from the Exchanger, is considered "boot" and is taxable. Example: Stewart sells his duplex, which he held for investment, for $160,000. A hundred calendar days later he closes on a different duplex, which he will hold for investment, for $110,000. Stewart receives the $50,000 in excess funds for his child's education. Stewart must pay capital gain taxes on $50,000. (In this example, Stewart chose to take some money out of his exchange and pay the capital gain taxes.)

WHEN ARE CAPITAL GAIN TAXES PAID?

Maybe never. Many investors mistakenly believe they will "have to pay the taxes sometime" so they might as well just sell. Quite often, this is a bad investment decision. The tax on an exchange is deferred into the future and is only recognized when an investor actually sells the property for cash instead of performing an exchange. Investors can continue to exchange properties as often and for as long as they wish, thus moving up to better investments and putting off the taxes for many years.

To learn more:

1) Call Asset Preservation toll-free at 800-282-1031
2) Visit API's website at www.apiexchange.com.

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