Key Questions And Answers About 1031 Exchanges

When selling a principal residence, qualified homeowners are allowed to take up to $500,000 in profits tax free. But what if you want to sell an investment property? Rather than pay taxes on profits from the sale, you can defer taxation by *exchanging* a qualified property for another "like-kind" property. It's called a 1031 exchange, named after Internal Revenue Code (IRC) section 1031. You may also hear it referred to as a "tax-deferred" exchange.

This brief report summarizes some of the basics involved in a tax-deferred property exchange. Due to the complexities and possible tax consequences of this type of transaction, be sure to consult a tax professional and/or a real estate attorney before attempting to execute a 1031 exchange.

Can I simply sell one property and buy another?

No. To reap the tax break, there must be an exchange, not just a sale and purchase of otherwise qualified properties. The exchange must be properly executed through an exchange agreement serviced by a "qualified intermediary" according to a specific process and timetable defined by the tax code.

What is a qualified intermediary?

Sometimes called a "facilitator" or "accommodator," a qualified intermediary (QI) functions as a middleman between you (the exchangor) and the buyers and sellers of the properties involved. Because you are not allowed to take physical possession or "constructive receipt" of the proceeds of the sale of your old property, the QI holds all the cash from the exchange until it is transferred to the seller of the replacement property. The QI facilitates the acquisition and transfer of the properties, providing documentation to ensure the exchange meets tax-code requirements. Your "exchange agreement" with the QI limits access to proceeds during the exchange, and may stipulate other services provided for the agreed-upon fee.

A QI must be an independent third party to the exchange. Neither you, your buyer or seller can serve as a QI in your exchange, nor can anyone who in the previous two years has been your employee, attorney, accountant, investment broker, real estate agent/broker or relative.

Be aware, there are no licensing requirements for QIs and the industry is largely unregulated. Because the QI is entrusted to hold all the funds involved in your 1031 exchange, it is important you select one that is reputable, experienced, financially sound and bonded.

What types of property can be exchanged?

Real estate qualified for a tax-deferred exchange includes improved or unimproved property held for income, investment or business purposes. Both the old (relinquished) property and the new (replacement) property would have to fall within that definition for the transaction to be a qualified "like-kind" exchange.

You could, for example, exchange unimproved land for an improved property you intend to use as an investment or for your business — but not as your residence. Or, you could exchange ownership of one qualified property for ownership of multiple like-kind properties — and vice versa. A number of possibilities are available as are a variety of limitations.

Can I take some money out of the transaction by investing in a property of lower value?

To have a valid tax-deferred exchange, you must exchange the old property for a property of equal or greater value. If at the conclusion of the transaction you receive any cash, cash equivalents or non-like-kind property, you will owe capital gains taxes. Also note, a 1031 exchange only defers taxation until such time as you sell the replacement property and take the money.

Is there more than one way to structure a 1031 exchange?

There are four basic types of real property exchanges, each conducted according to timetables and rules outlined by IRC and Treasury regulations.

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