

1031 EXCHANGES

An IRS Sanctioned Tax Shelter

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If you own business or investment property and are thinking about selling, you need to consider a 1031 exchange – it could save you big bucks. Named for the Internal Revenue Code section sanctioning such transactions, 1031 exchanges, also known as “Like-Kind Exchanges”, offer a legitimate way to defer tax on the sale of business or investment property.

Generally, when you sell property, you must pay tax on the amount of profit resulting from the sale. This tax liability can potentially be more than one-third of the amount you thought you made on the sale. In a 1031 exchange, tax liability is deferred. Moreover, an individual may *permanently* avoid paying capital gains tax on property received in a 1031 exchange if the individual still holds the property received in the 1031 exchange at the time of the individual’s death. This avoidance results from the fact that the tax basis of the property is “stepped-up” to the fair market value when transferred to the taxpayer’s heirs, so that when the heirs sell it, there is no gain to be recognized. Sounds good, but how does it work?

In a 1031 exchange, the property to be sold (called “relinquished”) is exchanged for “like-kind” property. So instead of receiving money for selling your property, you receive a similar piece of property. 1031 exchanges are most commonly used for real property transactions, but can also be used for like-kind personal property. In order to be of “like-kind”, the property must be of the same type and/or character – real property for real property, personal property for personal property (swapping your Spiderman comic book collection for ocean-front property in Arizona does not qualify as a 1031 exchange). In recent years, more and more personal property is being transferred via 1031 exchanges.

Only property held for use in a trade or business or for investment qualifies for a 1031 exchange. This means that your house and car generally do not qualify, but rental property and business buildings, orchards, business vehicles, etc. generally do qualify. (You might even be able to claim that your Spiderman comic book collection is for “investment” purposes.) The use of the property is determined at the time of the exchange. So, it is possible to exchange an orchard for a

cabin on Lake Chelan, provided that at the time of the exchange you intend to use the cabin at least partly as a rental property.

There are four general types of 1031 exchanges: (1) simultaneous; (2) deferred; (3) reverse; and (4) build-to-suit.

The simplest form of a 1031 exchange is a simultaneous direct swap - you trade your property directly to someone in exchange for their property, and close the two transactions at the same time. The IRS used to require all 1031 exchanges to be simultaneous.

A deferred exchange generally occurs when you transfer the relinquished property to a qualified intermediary or trust/escrow account, where the proceeds from the sale of the relinquished property are held until a suitable replacement property can be secured. Since a deferred exchange is not simultaneous, it requires exact compliance with the strict timing constraints for identifying and acquiring replacement property.

In a deferred exchange, you may earn interest on the property to be received because of the "safe harbor rules" promulgated by the IRS. These rules also authorize the use of a qualified intermediary (as mentioned above), and allow you to make certain that you will actually acquire the replacement property (by using a security interest, guarantee, or trust/escrow account), but generally do not allow you to use exchange funds to pay off a mortgage on the relinquished property.

A reverse exchange occurs when you find a suitable replacement property but have not yet sold your relinquished property. In this situation, you can hire a qualified intermediary to acquire and hold the replacement property. Once suitable replacement property is secured, the qualified intermediary transfers the replacement property to you simultaneously with the disposition of the relinquished property. These are known as "parking" arrangements. (This is not unlike calling "dibs" as a kid.)

Build-to-suit exchanges often occur because you have a difficult time identifying suitable replacement property after you have transferred the relinquished property to a qualified intermediary. In such circumstances, you may consider replacement property upon which improvements need to be built. In order to qualify as a 1031 exchange, you cannot use exchange funds to improve the replacement property. Rather, the seller of the replacement property must arrange

for the improvements to be made and the cost of the improvements can be added to the purchase price. Build-to-suit exchanges may be simultaneous, deferred, or reverse. A variation of this type of 1031 exchange can be of great benefit when you want to build on real property that you already own.

1031 exchanges might not be flashy, but they offer a legitimate tax shelter that can save you big bucks – provided you execute them properly. In 2003, \$175 billion worth of property was involved in 1031 exchanges, according to Deloitte Tax, LLP. Do not sell business or investment property without considering a 1031 exchange.