The Tax Deferred Exchange
1031 EXCHANGE BASICS

The tax deferred exchange, as defined in Section 1031 of the Internal Revenue Code of 1986, as amended, offers investors one of the last great opportunities to build wealth and save taxes. By completing an exchange, the investor (Exchanger) can dispose of investment property, use all of the equity to acquire replacement investment property of equal or greater value, defer the capital gain tax that would ordinarily be paid, and leverage all of the equity into the replacement property. Two requirements must be met to defer the capital gain tax:

1. The Exchanger must acquire “like kind” replacement property
2. The Exchanger cannot receive cash or other benefits, unless the Exchanger pays capital gain taxes on this money.

In any exchange, the Exchanger must enter into the exchange transaction prior to the close of the relinquished property. The Exchanger and the Qualified Intermediary enter into an Exchange Agreement, which essentially requires that:

1. The Qualified Intermediary acquire the relinquished property from the Exchanger and transfer it to the buyer by direct deed from the Exchanger and
2. The Qualified Intermediary acquire the replacement property from the seller and transfer it to the Exchanger by direct deed from the seller.

The cash or other proceeds from the relinquished property are assigned to the Qualified Intermediary and are held by the Qualified Intermediary in a separate, secure account. The exchange funds are used by the Qualified Intermediary to purchase the replacement property for the Exchanger.

IMPORTANT CONSIDERATIONS FOR EXCHANGE

- Exchanges must be completed within strict time limits. The Exchanger has 45 days from the date the relinquished property sale loses to identify potential replacement properties. The purchase of replacement property must be completed within 180 days after the closing of the sale of the relinquished property.

- Identification of potential replacement properties must be specific and unambiguous, in writing, signed by the Exchanger, and delivered to the Qualified Intermediary or another party to the transaction as permitted by Treas. Reg. §1.103(k)-1(c)(2) prior to the end of the 45-day identification period. The list of identified potential replacement properties cannot be charged after the 45th day; the Exchanger must acquire from the list of identified properties or the exchange will fail.

- To avoid payment of capital gain taxes, the Exchanger should follow thee general rules: (a) purchase a replacement property with a value equal to or greater than the value of the relinquished property, (b) reinvest all of the exchange equity into the replacement property, and (c) obtain the same or greater debt on the replacement property as on the relinquished property. The Exchanger can replace debt with additional cash, but cash equity cannot be replaced with additional debt.

- The relinquished property must have been held by the Exchanger for business use or investment purposes and the Exchanger also must intend to hold the replacement property for business use or investment purposes.

The Exchanger should always discuss the intended exchange with their legal or tax advisor. This information is deemed reliable but not guaranteed.

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