

I.R.C. § 1031 REFERENCE GUIDE



QUALIFIED
INTERMEDIARY
SERVICES

IPE 1031
6150 VILLAGE VIEW DRIVE
SUITE 113
WEST DES MOINES, IA 50266
515.279.1111
888.226.0400
FAX 515.279.8788
WWW.IPE1031.COM

I.R.C. § 1031 PURPOSE:

Section 1031 allows owners of business and investment real property to defer payment of capital gains taxes by reinvesting proceeds from the sale of a currently owned property (relinquished property) into new like-kind property (replacement property).

TYPES OF EXCHANGES:

Delayed: A delayed exchange occurs when a taxpayer, utilizing the services of a qualified intermediary, first sells relinquished property and subsequently acquires replacement property. Subject to certain rules, the taxpayer has up to 180 days from the transfer of the relinquished property to acquire replacement property.

Reverse: A reverse exchange occurs when a taxpayer, utilizing the services of a qualified intermediary and an exchange accommodation titleholder (EAT), acquires replacement property before disposing of relinquished property. In a reverse exchange, Section 1031 requires that the EAT take actual title to the replacement property until the relinquished property is sold. A reverse exchange benefits a taxpayer when the taxpayer must purchase the replacement property before being able to sell relinquished property. To fall within the safe harbor of Section 1031, the transaction must be completed within the 180-day time period.

Improvement: Taxpayers who desire to construct improvements on replacement property, utilizing relinquished property proceeds on deposit with a qualified intermediary, can do so by structuring the transaction as an improvement exchange. Improvement exchanges are similar to reverse exchanges in that an EAT must take actual title to the replacement property while it is under construction. To fall within the safe harbor of Section 1031, the transaction must be completed within the 180-day time period.

QUALIFYING PROPERTY:

Real Property: Generally speaking, nearly all types of real estate are classified as like-kind to each other. So long as a piece of real property is used for investment or for use in a business, it will qualify for Section 1031 treatment. Examples of real properties that can be exchanged for one another include the following: rental properties, farms and ranches, office buildings, motels and hotels, golf courses, raw land, industrial properties, retail properties, storage units, vacation homes with certain limitations, leasehold interests of 30 years or longer in length, and certain other partial interests in real property.

As of January 1, 2018, personal property can no longer be exchanged.



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REASONS TO EXCHANGE:

Generally speaking, the principal advantage of a Section 1031 exchange is the ability to use the entire equity of a property owned by a taxpayer to acquire replacement property. Tax consequences of selling property are taken out of the equation and taxpayers are free to move equity into more lucrative or appropriate investments. Some specific reasons for using Section 1031 are as follows:

Consolidation or Diversification: A taxpayer may wish to decrease the number of properties held by exchanging out of multiple relinquished properties into fewer replacement properties. The effect could be reduced managerial and maintenance burdens. Alternatively, a taxpayer may wish to exchange out of one high value property into multiple properties to limit investment exposure, diversify holdings, or increase cash flow.

Relocation of Investment: Taxpayers who relocate from one part of the country to another can utilize Section 1031 to move real property investments to the taxpayer's new location and avoid payment of capital gains tax.

Stepped-up Basis for Heirs: Heirs who inherit property from a taxpayer who has utilized Section 1031 to defer taxable gain through the life of the investment will acquire the property at a stepped-up basis. The effect being that the heir's basis equals the fair market value (FMV) of the property at the time of the taxpayer's death and no tax will be paid by the heir to the extent the sale price does not exceed the FMV at the time of death.

IMPORTANT RULES AND RESTRICTIONS:

45-Day Identification Rule: After a taxpayer transfers the relinquished property, replacement properties must be identified by the 45th day following the transfer.

Three-Property Identification Rule: A taxpayer may identify up to three properties without regard to the relinquished property's FMV.

200% Identification Rule: A taxpayer may identify any number of properties, so long as the aggregate FMV of all identified properties does not exceed 200% of the FMV of the relinquished property on the date it was sold.

95% Identification Rule: A taxpayer may identify any number of properties, without regard to FMV, so long as 95% of the value of the identified properties is actually acquired within the exchange period.

180-Day Exchange Period Rule: Closing on all replacement properties must occur by the end of the 180th day following the transfer of the relinquished property; or, the due date for the taxpayer's federal tax return for the year in which the property was relinquished, including extensions.

TO AVOID ALL TAXABLE GAIN, the general rule is that taxpayers must acquire replacement property that has a FMV equal to or greater than the FMV of the relinquished property, and all equity must be reinvested into the replacement property.

SAMPLE COOPERATION LANGUAGE:

Purchase and sale contracts for Section 1031 transactions should contain cooperation language. An example follows. The sample language should be modified to fit the specifics of each particular transaction.

Buyer or Seller may choose to transfer the subject property pursuant to Internal Revenue Code Section 1031, which sets forth the requirements for tax-deferred real estate exchanges. Either party's rights and/or obligations under this and future agreements may be assigned to a qualified intermediary or exchange accommodation titleholder for the purpose of completing an exchange. The parties agree to cooperate with each other in a manner necessary to enable completion of an exchange. Such cooperation shall be at no additional cost or liability to a non-exchanging party.