GUIDE TO IRS SECTION 1031 EXCHANGES

- **What is a Section 1031 Exchange?**

When selling a business or investment property, a taxpayer is generally required to pay taxes on the capital gains of this sale in the year that the property is sold. The IRS has created an exception to this rule, a Section 1031 Exchange, permitting taxpayers to trade property or reinvest proceeds from the sale of such property into another similar, like-kind "replacement" investment or property, and defer capital gains tax that would usually have to be paid.

- **Which Type of Property Applies?**

Most real estate property will qualify for such exchanges, as long as the property is used in trade, business, or investment (personal residences do not apply). When a taxpayer eventually sells the replacement property acquired through this 1031 exchange, the tax basis of the formerly owned property will be applied in determining taxes.

- **Nuts & Bolts of the Section 1031 Exchange Process**

The least complicated, though infrequent Section 1031 Exchange, involves two parties who simultaneously and directly exchange property. This rarely occurs. More commonly, a deferred exchange structure allows Exchanger time to identify a potential replacement property after a property is sold or relinquished. The steps are as follows:

1. Exchanger engages a Qualified Intermediary, an independent third party defined by IRS Treasury Regulations, which assists to prepare documents and facilitate a Section 1031 Exchange.
2. Exchanger enters into a typical attorney prepared contract to sell a property with a buyer, the proceeds of which are sent to the Qualified Intermediary.
3. This commences a 45 day window with which Exchanger has to identify potential replacement property targets following at least one of the below IRS mandated rules:

a. 3 Properties, regardless of their value, must be identified.
b. Any number of properties can be utilized in a Section 1031 Exchange, as long as the aggregate Fair Market Value does not exceed 200% of the relinquished property.
c. If Exchanger identifies more than 3 properties worth more than 200% of relinquished property, an exception exists allowing Exchanger to proceed if it acquires 95% of the value of the identified properties.

4. The sale also commences a 180 day window to secure the purchase of a replacement property, or the date the Exchanger must file its tax returns for the year.
5. If such a property is found and acquired, Exchanger is given the deed from the Seller and the Seller is paid by the Qualified Intermediary.
6. The same entity used for the sale of the property must be used to acquire the replacement property for tax benefits to apply (same tax ID).
7. To receive a 100% deferral of capital gains tax due on sale, Exchanger must either:

a. Purchase a property that is at least equal in value to the property it sells, or pay tax on the difference.
b. Reinvest the entirety of its net proceeds from the sale into the replacement property, or pay tax on the difference.
c. Obtain equal or greater financing for the purchase of the replacement property (or add funds to offset a debt reduction).

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