1031 Tax-Deferred Exchanges – Building Wealth through Real Estate
By Andrew G. Poulos, EA, ABA, ATP

Is it possible to build wealth *and* achieve the American Dream during a time when not only the American economy, but the global economy, is in a severe recession? Although many people are unemployed and struggling to pay bills and put food on the table, there is a huge opportunity for those who have the ability and the determination to purchase real estate. If you look at history, you will see that challenging economic times always create an opportunity to build wealth.

Owning real estate has traditionally been called the *American Dream.* Achieving the American Dream is a great feeling, but it's even better to own real estate and use the 1031 tax-deferred "like-kind" regulations to build wealth. Oftentimes, real estate owners want to sell their property and defer taxes. They think that the process is simply to sell their property and complete the like-kind exchange paperwork when they file their tax return. Unfortunately, those who do not seek professional advice get it wrong and the result ends up costing them money.

Qualifications for a 1031
The 1031 tax-deferred laws are very specific and involve strict timelines for selling a property and purchasing a replacement property. Aside from the timeframes that must be followed, there are other requirements that must be met in order to successfully qualify for a like-kind exchange.

First, in order to qualify for a 1031 tax-deferred exchange, the property must be held for productive use in a trade or business, or for investment purposes, and must be exchanged for "like-kind" property that will also be held for the same purpose. Like-kind does not mean *exactly* the same. For example, a single-family rental property can be exchanged for a warehouse, retail center, office building or farm property.

Once it has been determined that the property qualifies for a like-kind exchange, the identification period and exchange period requirements must be met in order to qualify for a tax deferral. The replacement property must be identified within *45 calendar days* of the transfer of the relinquished property.

However, unlike other tax deadlines that roll over to the next business day if the deadline falls on a weekend or holiday, the identification period does not get extended under any circumstance. Getting this requirement wrong is a deal breaker and can cost the taxpayer tens

of thousands of dollars in unnecessary taxes. It is best to identify multiple properties during the identification period so you can have a back-up plan in case your first choice falls through. In the real estate world, deals fall through quite often for various reasons. Buyers find properties and get emotionally attached to them all too often. There should be no emotional attachment to a property if you are a serious real estate investor interested in profiting from an investment property.

After successfully identifying the replacement property, the purchase must be completed within the earlier of the *180-day exchange period* or the due date of filing the taxpayer's federal tax return for the year in which the property was relinquished, including extensions. If the requirements are met for a like-kind exchange, and the taxpayer purchases a replacement property that is equal to or greater in value than the relinquished property, the taxpayer will have a fully tax-deferred exchange.

The Role of the Qualified Intermediary

Aside from the requirements discussed above, a tax-deferred exchange requires a seller to use a Qualified Intermediary (QI) who will handle the exchange process and the funds from the sale of the relinquished property. All too often, the seller is not aware that a QI must handle the process and hold the sales proceeds in escrow. If the seller is either in actual or constructive receipt of the cash proceeds, the tax-deferred exchange is terminated. Therefore, it is imperative that the seller use a reputable QI to handle the 1031 tax-deferred exchange.

A QI truly needs to be qualified – or the 1031 tax-deferred exchange process can turn into a disaster … and, not everyone can be a QI. Relatives or anyone who, within a two-year period prior to the exchange has acted as the seller's attorney, accountant, real estate broker or agent, are disqualified from being a QI. Unfortunately, for the seller, the people that are in their trusted inner circle can't act as their QI.

The Qualified Intermediary will facilitate the 1031 tax-deferred exchange transaction and guide the seller through the process achieving a successful tax-deferred exchange. The eight steps for a successful 1031 tax-deferred exchange process include the following:

1. Enter into a *purchase contact* with the buyer for the relinquished property. A "cooperation clause" assigning the contract to the QI should be included in the contract.

2. Exchange documentation should be prepared. Contact the QI to begin the tax-deferred exchange process. The QI will prepare the exchange agreement and have the purchase contract assigned to their company.

3. Closing of the relinquished property. The property will be conveyed to the buyer and the cash proceeds from the sale will be delivered to the QI.

4. The Qualified Intermediary will hold the cash proceeds and provide the necessary forms to identify a replacement property within the *45-day* identification period. Multiple properties should be identified to protect from any last-minute snags.

5. Enter into a *purchase contract* for the replacement property that is identified. The contract should have a "cooperation clause" as did the purchase contract for the sale of the relinquished property.

6. Exchange documentation should be prepared for the purchase of the replacement property. The contract will be assigned to the QI, notice of the assignment will be delivered to the seller of the property and instructions sent to the settlement agent.

7. The closing for the replacement property occurs. The Qualified Intermediary will deliver the exchange proceeds to purchase the replacement property for the buyer and the seller will convey the replacement property. Remember, the closing must occur within the earlier of *180 days* from the date of closing of the relinquished property, or the due date of the taxpayer's federal tax return.

8. Completion of the exchange process occurs. The QI will provide you with all the exchange documents, including proof of receipt and disbursement of all exchange funds. *Form 8824* must be filed with the taxpayer's tax return informing the Internal Revenue Service of the 1031 tax-deferred exchange.

A like-kind exchange is a great tool that real estate investors have at their disposal to defer capital gains taxes. As mentioned earlier, the like-kind exchange process is only for investment properties. The sale of a principal residence does not qualify for a 1031 tax-deferred exchange. Gain on the sale of a principal residence can be excluded under Code Section 121. Single taxpayers can exclude gains up to $250,000 and a married couple filing joint can exclude up to $500,000. It is also important to remember that vacation homes that are not rented out are not considered investment properties and therefore do not qualify for a tax-deferred exchange.

Tax-deferred exchanges are a powerful tool if used properly. They are more complex than they appear on the surface. Therefore, investors who want to sell property using the tax-deferred exchange laws must contact a professional for planning before they decide to sell their

investment property. One missed step or one missed deadline can be detrimental to the success of the transaction. However, a successful 1031 tax-deferred exchange affords bigger buying power and helps build wealth that otherwise may not be possible.

Let's look at the following example to see the difference in buying power for a transaction being sold using a tax-deferred exchange versus a non tax-deferred sale.

Like-Kind Exchange Example

- **$1,000,000 appreciation gain x 15% = $150,000**
- **$100,000 depreciation recapture x 25% = $25,000**

An investor acquires a commercial warehouse building for investment purposes in 2004 for $800,000. In 2012 the investor decides to sell the property and purchase a like-kind replacement property. The facts of the transaction are as follows:

1. The current mortgage balance on the property is $600,000.
2. The property has appreciated to $1,800,000 as of the latest appraisal done 15 days ago.
3. The depreciation deduction for the property is $100,000.

As can be seen in the table above, if the property is sold for the current value of $1,8 million without a tax-deferred exchange, the capital gains taxes will be $175,000. If the property is sold with a tax-deferred exchange, there will be zero capital gains taxes. By not selling under a tax-deferred exchange, the investor will have $1,025,000 for reinvestment, and with a like-kind exchange, the investor has $1.2 million to purchase a replacement property. Assuming a 30% down payment for the replacement property, the tax-deferred exchange gives the investor the ability to purchase a $4 million property compared to $3,416,667 if the sale does not occur as tax-deferred exchange.

Tax-deferred exchanges will soon become more popular then they have ever in our lifetime. With the current economic environment providing investors the opportunity to purchase foreclosure for pennies on the dollar, there will be large profits being cashed in when the economy turns around and property values begin to rise. Some will take the money, pay taxes and make other investments that are favorable to them at that time, while others will pursue tax-deferred exchanges in an attempt to defer taxes, increase their buying power and portfolios, and build wealth.

As a professional, you must not only advise your clients of the 1031 exchange laws, but you should help them understand the laws and how to use the process to build wealth. There is no greater satisfaction as a professional than seeing your clients become successful and knowing that you helped them achieve wealth. Making money is great, but providing excellent service and great knowledge to your clients brings the best satisfaction!

About the Author

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