The Tax Deferred Exchange

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 their investment property, use all of the equity to acquire replacement investment property, defer the capital gain tax that would ordinarily be paid, and leverage all of their equity into the replacement property. Two requirements must be met to defer the capital gain tax: (a) the Exchanger must acquire “like kind” replacement property and (b) 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 (a) the Qualified Intermediary acquires the relinquished property from the Exchanger and transfers it to the buyer by direct deed from the Exchanger and (b) the Qualified Intermediary acquires the replacement property from the seller and transfers 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 an Exchange

- Exchanges must be completed within strict time limits. The Exchanger has 45 days from the date the relinquished property closes to “Identify” potential replacement properties. This involves a written notification to the Qualified Intermediary listing the addresses or legal descriptions of the potential replacement properties. The purchase of the replacement property must be completed within 180 days after of the close of the relinquished property. After the 45 days has passed, the Exchanger may not change their Property Identification list and must purchase one of the listed replacement properties or the exchange fails!
- To avoid the payment of capital gain taxes the Exchanger should follow three general rules: (a) purchase a replacement property that is the same or greater value as 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 offset the amount of debt obtained on the replacement property by putting the equivalent amount of additional cash into the exchange.
- The Exchanger must sell property that is held for **income** or **investment** purposes and acquire replacement property that will be held for **income** or **investment** purposes.
- IRC Section 1031 does not apply to exchanges of stock in trade, inventory, property held for sale, stocks, bonds, notes, securities, evidences of indebtedness, certificates of trust or beneficial interests, or interests in a partnership.

Investment Property Exchange Services, Inc. is available to assist Exchangers and their advisors with their exchange strategies. **<u>The Exchanger is always advised to discuss the intended exchange with their legal or tax advisor.</u>**