Any real estate property owner or investor should consider a 1031 exchange when acquiring a replacement "like kind" property subsequent to the sale of his existing investment property. The basics behind a 1031 exchange is the strategy and method for selling one property, and then buying another property within a specific time frame in order to defer the payment of a capital gains tax (which is currently 15%). The entire transaction is treated as an exchange and not just as a simple sale.

There are two major rules to follow in a 1031 "like-kind" exchange.

1. The total purchase price of the replacement "like-kind" property must be equal to, or greater than the total net sales price of the relinquished real estate property.
2. All the equity received from the sale of the relinquished property must be used to acquire the replacement "like kind" property.

If the price of the replacement property is less than the total net sale price, a tax liability will be incurred for the difference. This is a partial 1031 exchange and would only qualify for partial tax-deferral treatment. All of the sales proceeds must go through a "qualified intermediary" in order to take advantage of this tax deferral. A qualified intermediary must be used to facilitate the 1031 exchange and cannot be someone with whom the parties has had a former business or family relationship. The qualified intermediary is an independent and professional facilitator who receives the funds, holds the funds, and distributes them when the transactions occur.

Both properties in a 1031 exchange rule must be "like kind". This means they must both be held for an investment purposes in a business or trade. Personal residences do not qualify for a 1031 exchange, but there is another exclusion property owners can take advantage of. The 121 exclusion in the Internal Revenue Code states if the residence is the primary residence for 2 of the last 5 years, the property owner can exclude up to $250,000 from the taxable income ($500,000 for married couples filing joint income tax returns).

There are 2 timelines that are important to a 1031 property exchange. This is the identification period and the exchange period. During the identification period, the party selling the property must identify other replacement properties that he wants to buy within 45 days from date of sale of the relinquished property. During the exchange period, the party who sold the relinquished property must close on the replacement property within 180 days from the sale.

The main benefit of a 1031 exchange is the deferral of capital gains tax, which can be significant depending on the price of the properties involved. It is important to work closely with your accountant, tax advisor and real estate attorney to find the best structure of transactions for your needs. Often times a 1031 exchange can be combined with the 121 exclusion for complete tax deferrals on more complicated transactions. Additionally, an investor may want to buy multiple properties requiring a more complex 1031 exchange. The limitation is three properties but there are different ways to complete the transactions in order to maximize the 1031 benefits. For further information on your real estate property needs, come into our office and speak with one of our qualified attorneys.