Gain 1031 Exchange

gain1031exchangecompany.com

Creating Comfort with The Exchange Process™

What is a 1031 Exchange?

When selling real estate, there may be capital gains tax due on that sale. A 1031 Exchange is a way to defer payment of capital gains tax on the sale of real estate. By exchanging, the seller is able to avoid payment of tax and use what would otherwise be a tax liability, as funds to invest in other property. The name 1031 Exchange comes from Section 1031 of the Internal Revenue (Tax) Code which authorizes such exchanges. As the name describes, the seller cannot sell the property outright. To have a valid exchange, the property must be exchanged for other property purchased through a specific process.

When completing an exchange, the tax code prohibits a seller from taking receipt of the proceeds funds upon the sale of their relinquished property. A Qualified Intermediary holds those funds and applies them to the exchanger's replacement property purchase. The Intermediary also facilitates the transfer of the properties as required by the tax laws.

At Gain 1031 Exchange Company we are a Qualified Intermediary and we assist with the exchange process including providing the paperwork to document the exchange properly and coordinating the necessary steps with the title closer or attorney.

In a typical 1031 Exchange, the exchanger sells their relinquished property and then acquires a replacement property in that order. It is possible to complete a Reverse 1031 Exchange where the replacement property is acquired before the relinquished property is sold. The process for a reverse exchange is much more complex than a forward exchange.

When Should a Person or Company Consider an Exchange?

There are many factors that must be considered to determine if an exchange will work for any seller, however, the main questions to ask are 1) Will there be capital gains tax due upon the sale of property and 2) Does the seller want to continue to own real estate?

If the answer is yes to both of these questions, then a 1031 Exchange is an excellent tax avoidance tool.

Who Can Complete an Exchange?

Any taxpaying individual or entity can take advantage of an exchange including businesses, partnerships, LLCs and corporations. The person or business entity who owns the property being sold is the taxpayer doing the exchange. That same taxpayer must be the one who takes title to the new replacement property that is purchased as part of the exchange. Some advanced planning may allow a deviation from this rule for situations such as a split up of partners in a partnership.

Additionally, the Internal Revenue Service pays attention to an exchange involving a party related to the exchanger such as a parent, sibling or related business. Further investigation may be needed to determine the validity of an exchange if a related party is involved, particularly when the related party is the seller of the new replacement property.

What Property Can Be Part of a 1031 Exchange?

Section 1031 of the Internal Revenue Code states that property must be exchanged for property that is of "like kind." This language often produces some confusion. Exchangers tend to think they need to exchange properties that are of similar use. Actually, all real estate in the United States is considered like kind to other real estate so long as it is held for productive use in a trade or business or for investment purposes. For example, a duplex can be exchanged for a fourplex, rental property can be exchanged for retail property, office property can be exchanged for a warehouse, land can be exchanged for improved property etc.

Property used strictly for personal use such as a primary residence or a vacation home will not qualify for an exchange since it is not held for use in a trade or business. There are some specific rules that <u>will</u> allow a vacation property to qualify for a 1031 Exchange if those rules are followed. Section 1031 also excludes property that is "held primarily for sale." This encompasses property that is the inventory of a developer/dealer and property that is intended to be resold or flipped.

An exchange can also include property that is constructed during the exchange, if certain procedures are followed.

How to Achieve Maximum Tax Deferral?

To achieve maximum tax deferral upon completing a 1031 Exchange, the exchanger must avoid receipt of the proceeds from the relinquished property sale and purchase a replacement property that is equal or greater in value than the value of the relinquished property that was sold. Any proceeds received or decrease in replacement property value will likely be taxed as capital gain. An exchanger can still complete an exchange with some partial tax deferral, even if these rules are violated, depending on the relinquished property's basis. Of course, an exchanger should always work with their tax professional to determine if an exchange is right for them.

What is the Role of the Intermediary in a 1031 Exchange?

The term Qualified Intermediary is a creation of the Internal Revenue Code (Section 1031 of course). Since the tax laws restrict the exchanger from taking receipt of the proceeds funds upon the sale of their relinquished property, a Qualified Intermediary is used to hold those proceeds. The intermediary will also prepare the exchange documents. To qualify, the intermediary must be an independent third party from the exchanger and cannot be the exchanger's agent, related to the exchanger or related to the exchanger's agent. For instance, an attorney or real estate broker where that attorney or broker has provided services to the exchanger is considered the agent of the exchanger and cannot act as that exchanger's intermediary nor can a title company owned by that agent.

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How do I Begin an Exchange?

Please contact us once you put your property on the market. At that stage, we will be able to answer any questions and advise on any steps necessary to make sure the exchange is done correctly. Once an offer to purchase the property is received, please notify our office and we will begin setting up an exchange file. Typically, we will make arrangements with the title closer to have the exchange documents signed at the closing. Remember, it is important that an exchanger not take receipt of the proceeds from their property sale. If the exchanger touches the proceeds, an exchange is no longer possible.

What is the Exchange Process?

The process for a forward 1031 Exchange (reverse exchanges are structured differently) involves seven simple steps:

1. TAX ADVISOR: The exchanger (the individual or business selling property) should consult with a tax advisor to determine if a tax deferred exchange is appropriate and is compatible with overall investment goals.
2. CONTACT GAIN 1031 EXCHANGE: The exchanger contacts Gain 1031 Exchange Company once a closing is scheduled on the relinquished property. Gain 1031 will work with the title company or attorney closing the transaction to prepare exchange documents.
3. CLOSING ON THE RELINQUISHED PROPERTY: At or before closing of the relinquished property, the exchanger, working with the title company closer, will sign the exchange documents and proceeds will be delivered to Gain 1031. An exchanger must not close on the relinquished property without having an exchange agreement in place.
4. IDENTIFICATION DEADLINE: Within 45 days after the closing of the relinquished property, the exchanger notifies Gain 1031 in writing (forms provided by Gain 1031) of the replacement property(ies) that the exchanger intends to acquire.
5. CONTACT GAIN 1031: The exchanger contacts Gain 1031 when a closing on the replacement property(ies) is scheduled.
6. ACQUISITION DEADLINE: The exchanger closes on the replacement property(ies) within 180 days (or less if the due date of the exchanger's tax return falls within the 180 days unless an extension is filed) from the closing on the relinquished property. Gain 1031 will prepare documents and wire the exchange funds to the title company or attorney closer.
7. ENJOY: The exchanger files their tax return reporting the exchange and enjoys the benefits of tax deferral.