



**BASICS**

**OF A**

**1031**

**EXCHANGE**

## **BASICS OF A 1031 EXCHANGE**

As an introductory matter, you should know three things about Section 1031 exchanges:

- You can exchange your property for new property without paying federal income tax on that exchange if the requirements of Section 1031 are met.
- The exact structuring of the exchange will depend on, and can be tailored to, your circumstances.
- You should obtain sound legal and tax advice before undertaking a Section 1031 exchange.

Section 1031 of the Internal Revenue Code (IRC) provides property owners a mechanism to exchange property they hold for investment or business purposes in return for property that is "like-kind." The benefit of a Section 1031 exchange, when compared to a sale of that same property followed by a reinvestment of the after tax proceeds, is that no tax is due on the exchange.

Therefore, engaging in a like-kind exchange permits the property owner to reinvest 100% of the proceeds which would result from a straightforward sale of existing property (the "relinquished property") in the new property that is acquired in the exchange (the "replacement property"). In contrast, an actual sale of the relinquished property followed by the payment of tax would leave only 80% or less of the proceeds available for reinvestment.

### **Qualifying Property**

There are a number of requirements that must be met in order for you to be able to engage in a Section 1031 tax deferred exchange. Most importantly, both the relinquished property and the replacement property must be held for "productive use in a trade or business" or "for investment." The "like-kind" property qualifying rules are broad with respect to real estate.

Any real estate property can be exchanged for another real estate property regardless of use. For example, land can be exchanged for a hotel. However, the qualifying rules for personal property are more restrictive and focus on the use of the property. For example, an aircraft can be exchanged for another aircraft, but an aircraft cannot be exchanged for a rail car.

## Getting Sound Advice

While the rules governing Section 1031 transactions are important and must be observed in order to complete a successful tax free exchange, Section 1031 transactions can be achieved in most instances provided you receive appropriate advice. Gulf South Exchange, LLC is owned by real estate attorneys; however, our attorneys are not licensed in every state. Therefore, it is important that you receive sound legal and tax advice from a trusted advisor.

Gulf South Exchange, LLC plays the role of the "qualified intermediary." Under the Section 1031 regulations, use of a qualified intermediary greatly enhances the prospects of successfully completing a valid Section 1031 exchange that will be respected by the IRS.

## Delayed or Starker Exchanges

Most Section 1031 Exchanges take place as "delayed" or "Starker" exchanges. This is so because, typically, a property owner ("exchanger") will find a buyer for the relinquished property before he/she has found suitable replacement property.

Section 1031 recognizes this practical reality and allows the exchanger to transfer the relinquished property before the replacement property is received in completion of the exchange. These delayed exchanges are also called Starker exchanges because, the courts first held that a delayed exchange can qualify for tax deferral under Section 1031 in the case of *Starker v. United States*, 602 F.2d 1341 (9th Cir. 1979).

If you wish to complete a successful delayed exchange, there are two critical deadlines that you need to strictly observe:

- You must identify the replacement property that you wish to receive in the exchange within 45 days of the closing of the relinquished property.
- The closing on the replacement property must take place before the earlier of (a) the elapse of 180 days following the relinquished property closing or (b) the filing deadline (taking into account extensions actually obtained) for your tax return for the year in which the relinquished property was given up.

## **Crucial Role of the Qualified Intermediary**

When undertaking a delayed or Starker exchange, it is essential to engage the services of a qualified intermediary, such as Gulf South Exchange, LLC. To qualify under Section 1031, you must effect an exchange of properties in a way that does not allow the IRS to argue that you actually or constructively received the proceeds of the sale of the relinquished property. If you do receive those proceeds (actually or constructively), you will be treated as having sold the relinquished property and purchased the replacement property rather than having completed a qualifying Section 1031 exchange.

The qualified intermediary allows you to avoid these issues in the delayed exchange context by closing on your relinquished property and forwarding it to your buyer and then closing on the replacement property and directing the seller to deed the replacement property to you. In the absence of a qualified intermediary at the center of the two transactions, you would need to make other arrangements to achieve your objective of transferring your relinquished property in exchange for the replacement property. For various reasons, persons (such as the third party seller of the replacement property) that are not in the business of facilitating Section 1031 exchanges may be unwilling to assist you in this regard.

## **Ten Basic Steps to a Delayed Exchange**

- You negotiate a purchase and sale agreement with respect to your relinquished property.
- You enter into an Exchange Agreement with a qualified intermediary such as Gulf South Exchange, LLC.
- You assign your rights under the Sale Agreement to the qualified intermediary.
- The closing ("first closing") on the relinquished property occurs with you executing a direct deed to the purchaser.
- The proceeds of the first closing are placed in an escrow account to be used in obtaining the replacement property. Gulf South Exchange, LLC deposits the proceeds of the first closing in dual signature escrow accounts with prestigious financial institutions so that you are assured that the proceeds of the first closing will be safeguarded

and will be used only to acquire the replacement property and to pay related closing costs with the account balance then paid over to you following the close of the delayed exchange.

- Within 45 days of the first closing, you complete an "Identification of Replacement Property" statement in which you identify (within certain limits) the replacement property you intend to receive in completion of the exchange.
- You negotiate a purchase and sale agreement with respect to the replacement property.
- You assign your rights under the purchase agreement to the qualified intermediary.
- Within 180 days (or by the time your tax return for the year of the exchange is due, whichever is earlier), the closing on the replacement property (the "second closing") must occur.
- At the second closing, the seller of the replacement property will be directed to transfer title to the replacement property to you; the seller is paid out of the funds in the escrow account established upon the first closing. If any other funds are required, they are provided by you or a lender. The qualified intermediary provides a reconciliation of the escrow account and the appropriate tax forms (Form 8824) are completed and included with your tax return for the year that the exchange takes place.

### **Alternate and Multiple Properties**

You may identify more than one replacement property. Regardless of the number of relinquished properties transferred as part of the same deferred exchange, the maximum number of replacement properties that you may identify is:

- Three properties without regard to the fair market values of the properties (the "3 property rule"), or
- Any number of properties as long as their aggregate fair market value as of the end of the identification period does not exceed 200 percent of the aggregate

fair market value of all the relinquished properties as of the date the relinquished properties were transferred by you (the "200% Rule").

If, as of the end of the identification period, you have identified more properties as replacement properties than permitted by the regulations, you are treated as if no replacement property has been identified.

***IF YOU HAVE ANY QUESTIONS ABOUT THE MECHANICS OF A SECTION 1031 EXCHANGE, PLEASE DO NOT HESITATE TO CALL OUR OFFICE ANY TIME.***

***WHILE WE MAY NOT BE ABLE TO GIVE YOU PERSONAL LEGAL ADVICE ABOUT YOUR SPECIFIC SITUATION, WE ARE GLAD TO HELP YOU FACILITATE YOUR EXCHANGE AND CONDUCT YOUR AFFAIRS IN A PROFESSIONAL MANNER SO THAT YOUR TAX EXPOSURE IS AT AN ABSOLUTE MINIMUM (IF ANY AT ALL).***