Doron F. Eghbali Taxation/Real Estate Law

What is 1031 Exchange?

Wednesday, January 27, 2010 by Doron F. Eghbali

In general, 1031 exchange is a swap of one business or investment asset for another. If you comply with the rules, no or little tax may be incurred upon exchange.

SOME BASICS OF 1031 EXCHANGE

- The IRS would not impose taxes upon cashing out or recognizing capital gains.
- The 1031 Exchange would allow your business or investment swap to grow tax deferred.
- There is no limitation on how many times you can do a 1031 exchange. In other words, you can rollover gain from one piece of property to another, another, and another.
- Despite having a profit on each swap, you defer paying any taxes until you actually sell the property or investment asset for cash many years later.
- When you actually sell the asset for cash, then hopefully you will pay only one tax at long-term capital gain rate, currently at 15%.

NOTES

1. Delayed Exchange: Usually, it is usually very hard to find somebody who has the property that you want and is willing to buy the property you have. As a result, the majority of exchanges is done in what is termed three-party or "Starker" exchanges, named after the first tax case that made this option available.

- In a delayed exchange, a middleman holds the cash after you sell the property, and the middleman uses the money to buy you another property. The IRS still recognizes this three-party exchange a swap.

2. Designation of Replacement Property

- **Timing of Notifying the Intermediary within 45 Days of Sale:** After sale of property, your middleman or intermediary will receive the cash. It is very important you do not receive the cash in order not to disqualify yourself from using 1031 exchange. Within 45 days of selling the property, you must notify the middleman in writing of the specified replacement property you intend to acquire.
- **Specifying Multiple Replacement Properties:** The IRS allows you to designate up to three replacement properties, as long as you ultimately close on one of them. However, you can potentially designate an unlimited number of potential replacement properties, as long as the fair market value of the replacement properties does not exceed 200% of the aggregate exchanged properties.
- **Closing on the Designated Replacement Property Within 180 Days of Sale:** You have only 180 days, six months, to close on one of your designated properties that you have

notified your intermediary of in writing. This is very important to note that the 180 days run concurrently with the 45 days. This means if you notified the intermediary of the replacement property in writing on the 44th day of sale, you only have 136 days left to close the transaction on of the designated properties.

3. Like-Kind Exchanges

You might also have heard of 1031 exchange as a like-kind exchange. This does not mean what you might think it means. This is a broad and enigmatic phrase. In fact, the rules are very liberal. You can exchange an apartment building for a raw land. But, as always there are hidden traps. For example, you might be hit with "*Depreciation Recapture*" tax. This happens when you exchange a property for which you claimed depreciation deduction for a raw land. The depreciation deduction will be taxed as an ordinary income.

CAVEATS

- **Not for Personal Property:** You cannot swap your primary residence for another home. In fact, 1031 exchange ONLY applies to investment and business property.
- **Loans and Mortgages:** This is very important to calculate how much in loans and mortgages you have in the property you are selling and how much mortgage you will have in the property you purchase. The reason is if your mortgage is less than what you previously had in the sold property, that portion will be considered "boot" and you will have to pay taxes on it as your ordinary income. For instance, if you had a 2 million-dollar mortgage on the property you just swapped and now your mortgage is only $1 million. You will,unfortunately, have to pay taxes on the $1 million difference.
- **Cash Left Over in Exchange:** If at the end of the exchange, there is still some cash left in the hands of the intermediary, you will receive it at the end of 180 days. The leftover is subject to capital gains tax.
- **1031 Exchange for *Some Personal Property*:** 1031 exchange is generally for real estate, but some personal properties could qualify, such as a painting. However, partnership interests and corporate stocks do not qualify.

DORON EGHBALI *is a Partner at the Beverly Hills Offices of Law Advocate Group, LLP. He Primarily Practices Business, Real Estate and Entertainment Law. He Could Be Reached at 310-651-3065 or DoronEghbali@LawAdvocateGroup.com. For More Information, Please,Visit: www.LawAdvocateGroup.com.*