

Five Misconceptions of 1031 Exchanges

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Over the past 20 years, tax-deferred exchanges have become an increasingly important part of real estate transactions. Surprisingly, there are still some deep-rooted misconceptions about Section 1031 of the Internal Revenue Code, even though tax-deferred exchanges are prevalent in the real estate community today. Some of these misconceptions are so severe that real estate investors wind up losing their chance to take advantage of the tax savings afforded by structuring their transactions as an exchange. What follows are the five biggest misconceptions:

1. In order to complete a 1031 exchange, a taxpayer has to find someone to “swap” a property with.

While this is originally how exchanges were structured, taxpayers are now free to sell their property to anyone they wish, and to buy from anyone they wish. Although there are a few issues regarding sales and purchases between related parties, most exchanges are structured not unlike any other typical sale and subsequent purchase commonly found in the industry.

2. A taxpayer seeking to exchange property has to buy the exact same type of property he is selling in order for it to be considered a “like-kind” exchange.

As long as both the property to be sold and the property to be purchased are held for productive use in a trade or business, or for investment purposes, taxpayers are free to purchase whatever type of property they want. For example, a taxpayer can sell an apartment building and exchange it for an industrial warehouse. Although exchanges are a creation of federal law, taxpayers must also look to state law to determine what is considered real property. Based upon state law, some non-traditional interests in real property such as development rights, air rights and timber rights can also be exchanged in the process.

3. Taxpayers must complete the 1031 exchange in one completely simultaneous transaction.

By virtue of a favorable ruling to the taxpayer in the now famous case of *Starker v. United States* in 1979, taxpayers have the ability to complete an exchange on a delayed basis so long as they purchase replacement property within 180 days of selling their first relinquished property. Other structures, including reverse exchanges and improvement exchanges, afford taxpayers other types of flexibility during the exchange time frame.

4. Taxpayers must use all the proceeds from the sale of their relinquished property to purchase replacement property.

In order to have a completely tax-deferred exchange a taxpayer must follow three essential steps: (1) buy replacement property where the value is equal to or greater than the value of the original relinquished property; (2) use all of the original equity realized from the sale to purchase a replacement property; and (3) obtain equal or greater financing on the replacement property as was paid off on the relinquished property at the time of its sale.

However, while those are the rules for a complete deferral, a taxpayer may violate any one of them and complete a partial deferred exchange. For example, a taxpayer who seeks to buy a replacement property of a lesser value, or with less financing, will recognize a capital gains tax on that amount not reinvested in the new property. Simply put, taxpayers can buy replacement properties for a lesser amount and put cash in their pocket, so long as they don't mind paying some taxes.

5. I don't need a qualified intermediary. I can simply have my attorney or accountant hold the sale proceeds until the replacement property is purchased.

A qualified intermediary is essential to completing a valid delayed exchange. Basically, the IRS disqualifies any person or entity from acting as an intermediary, if that individual has had an existing business relationship with the taxpayer within the past two years.

Although that statement is somewhat broad, some parties who may be considered disqualified parties are the taxpayer's relatives, attorney, accountant and real estate broker. The IRS provides that neither the taxpayer, nor any disqualified person or entity, can come into receipt of the exchange funds during the exchange, or the exchange will be void. Using a well-established qualified intermediary enables a taxpayer to avoid situations that might void an otherwise valid exchange. It is also a good practice to research the expertise and security of the qualified intermediary.