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THE TAX DEFERRED EXCHANGE

The tax deferred exchange, as defined in Section 1031 of the Internal Revenue Code of 1986, offers investors one of the last great opportunities to build wealth and save taxes. By completing an exchange, the investor (Exchanger) can dispose of their investment property, use all of the equity to acquire replacement investment property, defer the capital gain tax that would ordinarily be paid, and leverage all of their equity into the replacement property. Two requirements must be met to defer the capital gain tax: (a) the Exchanger must acquire "like kind" replacement property and (b) the Exchanger cannot receive cash or other benefits (unless the Exchanger pays capital gain taxes on this money).

In any exchange the Exchanger must enter into the exchange transaction prior to the close of the relinquished property. The Exchanger and the Qualified Intermediary enter into an Exchange Agreement, which essentially requires that (a) the Qualified Intermediary acquires the relinquished property from the Exchanger and transfers it to the buyer by direct deed from the Exchanger and (b) the Qualified Intermediary acquires the replacement property from the seller and transfers it to the Exchanger by direct deed from the seller. The cash or other proceeds from the relinquished property are assigned to the Qualified Intermediary and are held by the Qualified Intermediary in a separate, secure account. The exchange funds are used by the Qualified Intermediary to purchase the replacement property for the Exchanger.

IMPORTANT CONSIDERATIONS FOR AN EXCHANGE

Exchanges must be completed within strict time limits. The Exchanger has 45 days from the date the relinquished property closes to "Identify" potential replacement properties. This involves a written notification to the Qualified Intermediary listing the addresses or legal descriptions of the potential replacement properties. The purchase of the replacement property must be completed within 180 days after the close of the relinquished property. After 45 days has passed, the Exchanger may not change their Property Identification List and must purchase one of the listed replacement properties or the exchange fails.

To avoid the payment of capital gain taxes the Exchanger should follow three general rules: (a) purchase a replacement property that is the same or greater value as the relinquished property, (b) reinvest all of the exchange equity into the replacement property and (c) obtain the same or greater debt on the replacement property as on the relinquished property. The Exchanger can offset the amount of debt obtained on the replacement property by putting the equivalent amount of additional cash into the exchange.

The exchanger must sell property that is held for **income** or **investment** purposes and acquire replacement property that will be held for **income** or **investment** purposes.

IRC Section 1031 does not apply to exchanges of stock in trade, inventory, property held for sale, stocks, bonds, notes, securities, evidences of indebtedness, certificates of trust or beneficial interests in a partnership.

NON-TAX REASONS TO EXCHANGE

Generally, investors complete tax deferred exchanges to defer the capital gains tax on the disposition of their investment properties. However, there are many additional underlying reasons an investor might want to exchange one property for another. The motives often fall along standard risk - reward or cash flow - appreciation scales. These are some of the typical non-tax motives to exchange:

- Exchange from fully depreciated property to a higher value property that can be depreciated.
- Exchange from property that cannot be refinanced.
- Exchange from non-income producing raw land to improved property to create a positive cash flow from the rental income.
- Exchange from a property with maximized or minimal cash flow (apartment building) to a higher cash flow property (retail shopping center) to generate a larger cash flow.
- Exchange from a stagnant or slowly appreciating property to a property in an area with faster appreciation.
- Exchange for a property or properties that may be easier to sell in the coming years.
- Exchange to meet the client's location requirements.
- Exchange to fit the lifestyle of a client. For example, a retiree may exchange for a property requiring reduced management responsibility so they can do more traveling.
- Exchange from several smaller properties to one larger property to consolidate the benefits of ownership and reduce management responsibilities.
- Exchange from a larger property to several smaller properties. Exchanges can be used to divide an estate among several children or for retirement reasons.
- Exchange to a property the client can use in his or her own profession. For example, a doctor may exchange from a rental house to a medical building to use for his/her practice.
- Exchange from a partial interest in one property to a fee interest in another property.
- Exchange from a management intensive fee interest in real estate to a professionally managed triple net leased property where the lease, including options, has 30 or more years remaining.

TAX DEFERRED EXCHANGE TERMINOLOGY

As with any other specific area of real estate law, tax deferred exchanges under IRC § 1031 have their own language, which may be confusing to those who are unfamiliar with these transactions. The following are some the exchange terms and phrases that are often used with their "plain-English" interpretations.

1. **BOOT** – Fair Market Value of non-qualified (not "like-kind") property received in an exchange. (Examples: cash, notes, seller financing, furniture, supplies, reduction in debt obligations.) Receipt of boot will not disqualify an exchange, but the boot will be taxed to the Exchanger to the extent of the recognized gain.

2. **CONSTRUCTIVE RECEIPT** – A term referring to the control of proceeds by an Exchanger even though funds may not be directly in their possession.

3. **EXCHANGER** – The property owner(s) seeking to defer capital gain tax by utilizing a IRC § 1031 exchange.

4. **LIKE-KIND PROPERTY** – This term refers to the nature or character of the property, not its grade or quality. Generally, real property is "like-kind" as to all other real property as long as the Exchanger's intent is to hold the properties as an investment or for productive use in a trade or business. With regards to personal property, the definition of "like-kind" is much more restrictive.

5. **QUALIFIED INTERMEDIARY** – The entity that facilitates the exchange for the Exchanger.

6. **RELINQUISHED PROPERTY** – The property "sold" by the Exchanger. This is also sometimes referred to as the "exchange" property or the "downleg" property.

7. **REPLACEMENT PROPERTY** – The property acquired by the Exchanger. This is sometimes referred to as the "acquisition" property or the "upleg" property.

8. **IDENTIFICATION PERIOD** – The period during which the Exchanger must identify Replacement Property in the exchange. The Identification Period starts on the day the Exchanger transfers the first Relinquished Property and ends at midnight on the 45th day thereafter.

9. **EXCHANGE PERIOD** – The period during which the Exchanger must acquire Replacement Property in the exchange. The Exchange Period starts on the date the Exchanger transfers the first Relinquished Property and ends on the earlier of the 180th day thereafter or the due date (including extensions) of the Exchanger's tax return for the year of the transfer of the Relinquished Property.