The Resurgence of the 1031 Tax Exchange

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A 1031 tax exchange — also known as a like-kind or Starker exchange — is essentially a swap of one investment asset for another with either no tax or limited tax due at the time of the exchange. The gain on a real estate sale in 1031 is not recognized at the time of the sale.

Despite all the tax benefits, however, 1031 exchanges were few and far between during the most recent years of the recession since commercial properties were simply not being purchased and sold. However, with the economic rebound, an increase in the additional taxes aimed at the wealthy, and a capital gains rate that can go as high as 20 percent, 1031 exchanges are experiencing a resurgence.

In a 1031 tax-free exchange, an exchanger can sell a parcel of commercial investment property (referred to as the [illegible] property) and reinvest the sales proceeds in another parcel of property without any tax consequences. The seller's net proceeds from the relinquished property go into the hands of a qualified intermediary, who holds the funds in escrow until the seller reinvests the proceeds in a replacement property.

While the premise sounds simple, there are some caveats to consider. These include:

Time-sensitive time frame. Once an exchanger has sold the relinquished property, he has 45 days to identify the replacement property. In most cases, the exchanger can identify at least three separate parcels of the replacement property, and even more under certain circumstances. The exchanger also has 180 days from the initial sale to close on the replacement property. That means he has to go shopping in a hurry. One of the biggest challenges in 1031 is identifying adequate and appropriate investment property. Therefore, once a property owner begins contemplating the sale of the property, they should immediately begin pursuing a replacement property. In a reverse exchange, the exchanger can acquire the replacement property prior to the selling of the relinquished property. However, the replacement property must be held by an escrow agent until the relinquished property is sold.

Importance of a qualified and experienced intermediary. Intermediaries are required to be neutral, with no connection to the seller, so the seller's realtor and attorney cannot represent them as an intermediary. Most title insurance companies, however, have a tax-free exchange department and will be equipped with the appropriate documents and forms for a successful 1031 exchange. A good intermediary, which usually costs approximately $1,000, will also keep the taxpayer on task and informed of deadlines that need to be met.

Multiple replacement properties and potential tax consequences. While most investors purchase more expensive replacement properties, multiple parcels can be purchased in order to re-invest all of the proceeds from the sale of the relinquished property. In order for the exchange to qualify as fully tax deferred, it must meet two requirements: (1) the entire net proceeds must be reinvested and (2) the replacement property must be acquired with the same or greater debt. If the debt is reduced, the exchanger can add cash to the purchase price to offset the debt reduction.

Multi-member LLCs. The 1031 tax exchange is still available to one member in a multi-member LLC, even if all the other members want to cash out while he wants to reinvest. In this instance, the taxpayer can have his percentage interest in the property conveyed to him and he is then free to reinvest his portion in a replacement property on a 1031 exchange. However, that option is not extended to stockholders in a corporation. The consequence of corporate assets, when conveyed to a stockholder, triggers a taxable transfer.

As the economy becomes more robust and commercial transactions are on the increase, 1031 tax exchanges should be considered, especially in light of the higher capital gains rate. 1031 allows sellers to dispose of investment property without paying capital gains tax or depreciation recapture tax. Consult with a qualified attorney or a title insurance representative for issues that should be considered in order to defer taxes.

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