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LAW: 1031 Exchanges

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See past myths

Once the province of commercial brokers, Internal Revenue Code section 1031 exchanges are increasingly being used by savvy residential investors to defer capital-gains taxes. Most people know the basics of a 1031, or like-kind, exchange: For a property you plan to sell, you have to identify replacement property within 45 days and close on the purchase within 180 days. Beyond that a lot of misinformation exists. Understanding these common misconceptions will help keep you and your client out of trouble.

Myth No. 1: The 180-day rule can be extended if Day 180 falls on a weekend or a holiday.

Like-kind exchanges must close no later than day 180 after the deed transfer date of the relinquished property. Closing in escrow doesn't count. There must be actual transfer of ownership. The U.S. Tax Court has reaffirmed it: If your client's 180 days are up on Sunday, you can't close on Monday; you have to close on the preceding Friday. The no-exception date rule also applies to the 45 days given to identify a property for exchange.

Myth No. 2: Residential properties transferred through a 1031 exchange must be used exclusively as rentals.

You can acquire a second home or vacation home with 1031 funds for personal use as long as you follow certain guidelines. First, the property needs to be placed in a rental pool and offered for rent at market rate. The exchanger can use the property for up to 14 days per year or 10 percent of the time the property is rented, whichever is greater. In addition, if the exchanger needs to perform maintenance on the property, the exchanger can stay in the property while that work is done.

Myth No. 3: Only developed properties qualify for like-kind exchanges.

Most people believe 1031 exchanges are limited to developed land and "sticks and bricks." But vacant land also qualifies. For instance, you can exchange an apartment building for vacant land. In addition, properties or land can be exchanged for anything else defined under a state's law as real estate. For example, in Colorado, the state's definition of real estate includes not only improved and vacant land, but also water rights, mineral rights, air rights, a leasehold interest in excess of 30 years, and even a contract to buy or sell real estate. A caution: Definitions of real estate vary from state to state, so be certain an asset is eligible as real estate before making an exchange.

Myth No. 4: Exchangers must purchase replacement properties that are equal in value to the property they're exchanging.

There's no limit to the value of the property an exchanger can buy as long as the exchanger identifies no more than three properties as possible replacement. For example, if an exchanger sold one property for $500,000, the exchanger could identify $10 million of replacement property. However, the minute exchangers identify more than three properties, the exchange falls under the 200 percent rule, which states that the properties can have an aggregate value of no more than 200 percent of the property they're replacing.
Fail to meet the 200 percent test, and the exchange falls under the 95 percent rule. Under this provision, exchangers must be able to close purchases on properties with a total value of at least 95 percent of the value of the property they're selling or the exchange will be disallowed by the IRS. Value is defined by the IRS as either the contract price or an appraised fair market value.

Myth No. 5: Your attorney or your real estate professional can act as the qualified intermediary who takes temporary title to the property for your exchange.

The Internal Revenue Code describes who can't be a qualified intermediary. The client's attorney can't serve as a QI if there's been an attorney-client relationship over the preceding two years, nor can the client's CPA if he or she has prepared the client's tax return within the last two years. A real estate licensee representing any party in the exchange is also excluded because of the agency relationship. To further confuse matters, there are no statutory requirements as to what constitutes a QI or the qualifications for becoming one.

Myth No. 6: When you exchange property via a 1031 exchange, you defer all tax liability.

Any cash not spent on the purchase of a replacement property during an exchange, called boot, is fully taxable, regardless of the client's adjusted basis on the property. This boot is taxed at federal capital gains tax rates (currently 15 percent). In addition, exchangers may owe capital gains taxes in the state in which the property is located. If exchangers depreciated the relinquished property for tax purposes after May 1997, they may also have to pay a recapture tax of 25 percent on any boot they receive.

Myth No. 7: A taxpayer can't complete a 1031 transaction with a related party.

Clients can use a 1031 exchange to buy property from or sell property to a related party, but the related party must then own that property for at least two years before selling or exchanging it. Otherwise the exchange is invalidated and the client may owe capital gains taxes. Under IRS rules, parents, spouses, siblings, and children—essentially any parties related by blood—are considered related parties.

The intricacies of exchanges are best handled by a team that includes you, the client, a

QI, and the client's attorney or CPA. Assemble that team before the client puts the property to be relinquished on the market. Otherwise, you run the risk of an error that could invalidate an exchange.

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